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No. ____

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

WHEREHOUSE ENTERTAINMENT, INC. et al.,

Petitioners,

—v.—

McMAHAN & COMPANY, et al.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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QUESTIONS PRESENTED

1. Where a prospectus pertaining to the sale of securities presents a "literally accurate" statement of all objective, material facts pertaining to those securities, may it nonetheless violate § 11 of the Securities Act of 1933 and § 10(b) of the Securities Act of 1934 because it did not *also* contain (a) subjective, pejorative characterizations of the "value" of those securities, (b) speculations concerning future circumstances which may arise which might affect the value of the securities, and (c) legal conclusions and interpretations concerning the rights of the security-holders and the fundamental legal principles of corporate governance?

2. Conversely, where a prospectus pertaining to the sale of securities discloses all material facts, can it be a violation of § 12(2) of the Securities Act for the seller to express a positive subjective characterization of those facts?

PARTIES TO THE PROCEEDING AND RULE 29.1 STATEMENT

In addition to the parties named in the caption, the following persons and corporations were defendants in the district court and appellants in the court of appeals and are petitioners in this Court:

Louis A. Kwiker
George A. Smith
Michael T. O'Kane
Lawrence K. Harris
Donald E. Martin
Joel D. Tauber
Furman Selz Mager Dietz & Birney, Incorporated[1]
WEI Acquisition Corp.
WEI Holdings, Inc.
Adler & Shaykin[2]

In addition to the parties named in the caption, the following persons and corporations were plaintiffs in the district court and appellees in the court of appeals and are respondents in this Court:

Froley, Revy Investment Co., Inc.
and Wechsler & Krumholz, Inc.

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1 Xerox Corp., through two wholly-owned subsidiaries, is the ultimate parent of Furman Selz Mager Dietz & Birney, Incorporated.

2 BAC Holdings Group, Inc., Modern Merchandising Inc., Best Products Co., Inc., Joy Technologies, Inc., The Sun-Times Company, Addiction Recovery Corp. and Folger Adam Corp. are subsidiaries of Adler & Shaykin.

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MCMAHAN & COMPANY, et al.,

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners respectfully request the issuance of a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit in this case.

OPINIONS BELOW

The opinion of the Court of Appeals (App., *infra*, 1a-15a) is reported at *McMahan & Co.* v. *Wherehouse Entertainment, Inc.*, 900 F.2d 576 (2d Cir. 1990). The District Court's opinion is reported at *McMahan & Company*, v. *Wherehouse Entertainment, Inc.*, [1989] Fed. Sec. L. Rep. (CCH) ¶ 94,510 (S.D.N.Y. May 25, 1989) (19a-31a).

JURISDICTION

The Court of Appeals entered its judgment on April 10, 1990 (16a-17a). A petition for a rehearing was denied on May 16, 1990 (18a). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATEMENT OF THE CASE

In this case a divided panel of the Second Circuit held that a prospectus pertaining to the sale of debentures, which it conceded presented a "literally accurate" recitation of all pertinent contractual provisions governing the rights of debentureholders, may nonetheless have violated the federal securities laws because it did not *also*: (1) characterize the rights as "illusory", (2) speculate as to the likelihood that these rights might be triggered by future events, and (3) explain that the directors of the company owed fiduciary duties to its shareholders, and not to debentureholders. This decision represents a drastic, and unwarranted, expansion of liability under the federal securities laws, by requiring disclosure, in addition to *facts*, of subjective characterizations, speculations and legal conclusions.

Plaintiff financial institutions are the record owners of Wherehouse Entertainment, Inc. ("Wherehouse") convertible subordinated debentures due July 1, 2006 (the "Debentures"). The Debentures were issued pursuant to an Indenture dated June 15, 1986 (the "Indenture") (62a-68a), and a Prospectus dated July 10, 1986 (the "Prospectus") (54a-61a). The Indenture, which is the contract specifying the rights of the debentureholders, contains an "optional right to tender" the Debentures to Wherehouse at a specified redemption price. This right to tender may be exercised only if certain transactions (such as a hostile takeover) occur which are *not* "approved by a majority of the Company's Independent Directors". Specifically, the Prospectus discloses that this "optional right to tender" would arise

> in the event that: (i) any person or group . . . attains beneficial ownership . . . of at least 80% of the voting power for election of the Company's directors *unless approved by a majority of the Company's Independent Directors*; (ii) the Company consolidates with, merges into or sells or leases its properties and assets substantially as an entirety to any person or entity, *unless approved by a majority of the Company's Independent Directors*; or (iii) the Company or any Subsidiary incurs Debt (*excluding . . . Debt authorized or ratified by a majority of the Company's Independent Directors*) whereby the Consolidated Total Debt of the Company exceeds 65% of its Consolidated Capitalization. . . .

(emphasis supplied) (59a). (*See also* Prospectus Summary, p. 2: virtually identical language (57a-58a)).

As the District Court observed, "The prospectus . . . essentially recites *verbatim* the Indenture's description of the right to tender," (21a). As is readily apparent both from the Prospectus and the Indenture, *no* triggering event giving rise to a right to tender occurs if the transaction is approved by a majority of the "Independent Directors" of Wherehouse.

Section 5.02 of the Indenture defines "Independent Director" as

> "a director of the company who is not, and has not been during the 5 years prior thereto, an employee of the Company and who either was a member of the Board of Directors of the Company on July 10, 1986, or who subsequently became a director of the Company and whose election, or nomination for election, by the Company's shareholders was approved by a vote of a majority of the Independent Directors then on the Board of Directors" (66a).

This definition was also set forth, virtually verbatim, on the *very same* page of the Prospectus that describes the optional right to tender.

On December 21, 1987, the board of directors of Wherehouse unanimously approved a merger agreement with defendants WEI Holdings, Inc. and WEI Acquisition Corp. Since that transaction was "approved by a majority of the Company's Independent Directors", under the terms of the Indenture the debentureholders' "optional right to tender" was not triggered.

Nonetheless, in this action plaintiffs allege that the approval of the merger violated the Indenture. While recognizing that the transaction does not contravene any express provision of the Indenture, plaintiffs allege that the Indenture implicitly imposes a fiduciary duty upon the directors requiring them not to approve any merger injurious to the debentureholders. Since this merger caused Wherehouse to incur substantial amounts of additional senior debt, plaintiffs allege that the transaction injured them and that the directors were therefore prohibited from approving it, even if the merger would have been of enormous benefit to the company and its stockholders.

In the event that the court finds that the Indenture imposes no such fiduciary duty, plaintiffs allege in the alternative that defendants violated § 11 of the Securities Act and § 10(b) of the Securities Exchange Act: (1) by "failing to disclose" in the Registration Statement and the Prospectus that the optional right to tender was "illusory" and "worthless"; and (2) by stating that the decision as to whether to approve a merger would be made by "Independent Directors" without admonishing that directors owe their fiduciary duties to the shareholders, not to debentureholders. One of the plaintiffs also claims that the underwriter of the debentures violated § 12(2) of the Securities Act by orally representing that the optional right to tender constituted a "protective covenant", a characterization plaintiff contends is false because, in his opinion, that right is "illusory".

Proceedings In The District Court

Plaintiffs commenced this action on January 15, 1988, in the United States District Court for the Southern District of New York. The District Court referred defendants' motion to dismiss plaintiffs' amended complaint to a Magistrate for a Report and Recommendation.[3] In a 32-page Report and Recommendation dated August 8, 1988, the Magistrate recommended that summary judgment be granted for defendants on plaintiffs' federal securities claims and that the pendent state law claims be dismissed for lack of pendent jurisdiction (32a-53a).

In its Opinion and Order dated May 22, 1989 (19a-31a), the District Court granted summary judgment for defendants on the grounds that (1) the Prospectus disclosed, virtually verbatim, all pertinent provisions of the Indenture, and (2) the alleged misstatements and omissions all concerned legal conclusions, speculations about future events, and pejorative labels, none of which are "facts" which must be disclosed under the federal securities laws.[4] Because the federal claims had been dismissed, the court also dismissed the state law claims for lack of pendent jurisdiction.

The Decision Of The Court Of Appeals

The Second Circuit conceded that the Prospectus was "literally accurate" (6a). Nonetheless, a divided panel reversed the decision of the District Court and held, in effect, that truth is not enough: defendants may be subject to multi-million dollar liability under the federal securities laws because, in the view of the majority, the specific language of the Prospectus, which quoted the Indenture verbatim, might

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3 Defendants moved to dismiss pursuant to Rule 12(b)(6), Fed. R. Civ. P. Because defendants submitted, in support of their motion, copies of the Prospectus and Indenture, which had not been annexed to the Complaint or the Amended Complaint, the Magistrate converted the Rule 12(b)(6) motion into a Rule 56 motion for summary judgment (33a).

4 Plaintiffs' "Revised Amended Complaint" was dismissed pursuant to a judgment entered on June 7, 1989.

be read to imply that the debentureholders' rights are "valuable" and not "illusory":

> The offering materials can reasonably be read to present the option to tender as a valuable right . . . . The offering material stressed the purported value of the right in any takeover transaction which would threaten the value of the debentures (8a).

(900 F.2d at 579-80). The majority opinion concluded that such an inference would have been incorrect because the right to tender would more properly be characterized as "illusory" if the directors, in voting on a merger proposal, were not bound to conform their actions to the interests of debentureholders (10a). (900 F.2d at 580).

Central to the Second Circuit's analysis was its view that the use of the term "Independent Director" in the Prospectus might have falsely implied that these directors would be required to act as *de facto* debentureholder representatives:

> the term "Independent Director" implies a special status, some distinction from an "ordinary" director. The term suggests that these directors would be "independent" of management and the normal obligations of board members to act in the interests of shareholders (9a-10a).

(900 F.2d at 580). The court came to this conclusion notwithstanding the fact that (1) the Indenture specifically defined the term "Independent Director" as simply a director who was not a member of management; (2) the Prospectus recited that definition, virtually verbatim; and (3) the definition used by the Indenture was no different from the generally accepted definition of the term.

The majority opinion also took issue with an alleged oral statement by the underwriter of the Debentures to the effect that the right to tender constituted a "protective covenant" for debentureholders—a characterization which the court concluded was possibly at odds with the "illusory" nature of these rights (12a). (900 F.2d at 581). In holding that this

alleged statement might violate § 12(2) of the Securities Act, the court concluded that this alleged statement was "promissory and unrestricted" and "clearly impl[ies] that the protection to the debentureholders would extend to the case of any takeover hostile to the holders' rights."

In his dissent Judge Sand[5] concurred with the analysis of the Magistrate and the District Court (14a-15a). The dissent also observed that the federal securities laws do not require disclosures of such "fundamentals of corporate governance" as the fact that directors owe their fiduciary duties to shareholders, not debentureholders, and that those laws require nothing more than "the disclosure of material, objective factual matters". Notwithstanding the latter point, the dissent went on to dispute the majority's conclusion that the term "special protection" was not an appropriate characterization of the debentureholders' rights:

> The question whether an anti-takeover provision provides a "special protection" to debentureholders cannot be answered in the negative merely because the "Independent Directors" decided to waive its provisions and approve a particular transaction. These directors were explicitly empowered to act in this fashion by virtue of the fully disclosed terms of the provision. A significant function of an anti-takeover provision is to serve as a deterrent to hostile takeovers, including takeovers that would be contrary to the interests of both shareholders and debentureholders. [The option to tender provision was not] worthless to debentureholders even though as a matter of Delaware law directors owe a fiduciary duty solely to shareholders. The anti-takeover provision was therefore a "special protection" to debentureholders, albeit a limited one (14a).

(900 F.2d at 582).

On April 24, 1990 the defendants filed a petition for a rehearing, which was denied on May 16, 1990 (18a).

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5 United States District Judge Leonard Sand was sitting by designation on the Court of Appeals when this case was argued.

REASONS FOR GRANTING THE PETITION

First, the majority opinion below holds that liability under the federal securities laws need *not* be based on a misstatement or omission of material, objective facts, but can also be based on the use of subjective characterizations (such as "independent director" or "protective covenant") and the non-use of pejorative, subjective characterizations (such as "illusory" or "worthless"). The decision below thus contradicts innumerable decisions in other Circuits holding that the federal securities laws do not require that fully disclosed facts be embellished with pejorative characterizations. The decision below also contradicts the firmly established rule that the federal securities laws do not require the disclosure of legal conclusions or analyses, such as discussions of the fiduciary duties of directors, or speculation about future events, such as how directors might respond to any hostile or friendly merger proposals that might be received within the 20-year period during which the debentures would be outstanding.

Similar considerations are present in a case in which this Court recently granted certiorari, *Virginia Bankshares* v. *Doris Sandberg*, 110 S. Ct. 1921 (1990) (scheduled for argument on October 9, 1990). In that case, one of the issues certified for review was whether § 14(a) of the Exchange Act required parties to securities transactions not only to disclose material facts, but also "to characterize disclosed facts in a pejorative manner." *Virginia Bankshares* specifically raises the issue of whether a proxy statement violates the federal securities laws simply by characterizing as "independent" an investment bank which had opined on the fairness of a merger offer. In that case the disclosure documents revealed the objective facts concerning the relationship between the parties, from which an investor could draw his own conclusions. The same issue is posed here concerning the Prospectus' use of the term "independent director"—except that the case for reversal is even stronger here, since that term was expressly defined in the Prospectus.

The practical consequence of the majority opinion below may well be to foment an avalanche of strike suit litigations

under the federal securities laws, and likely RICO as well, challenging the choice of words used to characterize fully disclosed facts, or, worse, the *failure* to use pejorative characterizations of the facts. Indeed, the inference the court below found could be drawn from the use of the term "independent director" has the potential, in and of itself, to create a host of legal disputes; for independent directors have played an increasingly important role in corporate governance, and their activities are of necessity discussed in literally hundreds of disclosure documents issued each year.

Moreover, "poison puts", such as the optional right to tender at issue here, are common provisions found in hundreds of Indentures issued in recent years, to provide defenses against an increasing number of hostile acquisitions. *See* Herberling, "Event Risk Provisions Protect Bondholders Against Takeovers," *The National Law Journal*, June 5, 1989, p. 22, col. 1. The indentures of other publicly traded companies contain similar, and in some cases identical provisions;[6] and in many cases, debentureholders have subsequently been confronted by mergers or other highly leveraged transactions creating large amounts of senior debt. The Second Circuit's opinion below will therefore have a direct impact on many of those transactions.

Second, any requirement that disclosure documents provide legal analyses of contracts or the law regarding various aspects of corporate governance would wind up burying investors in a mass of legal trivia that would be as likely to mislead as to inform. Unlike objective facts, which exist as of

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6 *See, e.g., Turner Broadcasting System, Inc.* v. *CBS, Inc.*, 627 F. Supp. 901, 904 (N.D. Ga. 1985) ("limitation on additional debt" provision in CBS notes prohibited certain debt "unless such debt was authorized by a majority of the board's independent directors (which are defined as a director who is not and has never been an employee of the Company and who was either a member of the board on July 31, 1985, or who subsequently becomes a director of the company and whose election was approved by a majority of the independent directors then on the board"); American Bar Foundation, *Commentaries On Indentures*, §§ 10-11 (1971).

a particular date and can be objectively verified, legal analyses and conclusions are matters of judgment which are frequently subject to debate, and are always subject to drastic revision based on subsequent legislative enactments or judicial decisions. Consequently, to require such disclosures would more often than not be counterproductive.

The present action is a case in point. The issue of whether an indenture imposes a contractual fiduciary duty on the directors in favor of debentureholders is a disputed legal issue in this very litigation, as well as in several seminal decisions rendered long after these Debentures were issued. *See Simons* v. *Cogan*, Del. Supr., 549 A.2d 300, 303-04 (1988) (holding that no fiduciary duty to debentureholders exists under Delaware law, rejecting the contrary ruling in *Green* v. *Hamilton Int'l Corp.*, No. 76-5433 (S.D.N.Y., July 13, 1981)); *Metropolitan Life Ins. Co.* v. *RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1524 (S.D.N.Y. 1989) (adopting rule of *Simons* v. *Cogan*); *Hartford Fire Ins. Co.* v. *Federated Dept. Stores Inc.*, 723 F. Supp. 976 (S.D.N.Y. 1989); *see also "Bondholders Ponder Weapons in Era of Buyouts, ABA Group Told,"* Sec. Reg. & L. Rep. (BNA), Vol. 21, Apr. 14, 1989. Had defendants been required to provide legal advice on this question in the Prospectus, they would have run a high risk that whatever they said would have been wrong. The federal securities laws should not require parties, in disclosure documents, to predict correctly the future rulings of the courts.

Finally, the impact of the majority's decision below, while inconsistent with rulings in other Circuits, will have a disproportionate impact upon the securities markets. The Second Circuit handles more securities litigation than any other Circuit, and the liberal service and venue provisions of the securities laws enable plaintiffs from across the nation to sue in that Circuit. Thus, if the majority opinion below is permitted to stand its effects will be felt by litigants nation-wide.

I. THE FEDERAL SECURITIES LAWS DO NOT REQUIRE THE PEJORATIVE CHARACTERIZATION OF DISCLOSED FACTS

The Second Circuit accepted plaintiffs' argument that defendants failed to disclose that the right to tender was "illusory":

> "the plaintiffs are correct that the offering materials can reasonably be read to present the option to tender as a valuable right. . . . [T]here is merit to plaintiffs' contentions that the right to tender was illusory and that the representations of it in the offering materials were misleading . . . an investor could have reasonably believed that the tender option was presented as a valuable right for debentureholders" (8a, 10a, 11a).

(900 F.2d at 579, 581). Thus, the court apparently embraced the thesis that defendants had the duty to "disclose" that these rights were "illusory" or not valuable. Conversely, on the occasion where one of the defendants allegedly did use subjective language to describe these rights, the court held that liability could attach for that act as well, under § 12(2) of the Securities Act, because in its view the descriptive language used may not have been "accurate". Thus, it reinstated the claim of one of the plaintiffs against the underwriter for allegedly having described the optional right to tender as a "protective covenant".

Until the decision below (and *Virginia Bankshares*), the rule uniformly applied by the courts of appeal was that, having explicitly disclosed all objective facts, a party is under no obligation to provide inferences or conclusions to be drawn from those facts, or to characterize them in pejorative terms. *See Lessler* v. *Little*, 857 F.2d 866, 876 (1st Cir. 1988) (once the relevant facts of the transaction are disclosed, a shareholder has "no grounds under the 1934 Act for complaining about management's choice of words" in describing them) *cert. denied*, 109 S. Ct. 1130 (1989); *Kas* v. *Financial General Bankshares, Inc.* 796 F.2d 508, 517 (D.C. Cir. 1986) (a proxy

statement "need not label or editorialize on the disclosed facts"); *Data Probe Acquisition Corp.* v. *Datatab, Inc.*, 722 F.2d 1, 5-6 (2d Cir. 1983) (the required disclosure is not a "right of confession or exercise in common law pleading. What is required is the disclosure of material objective factual matters"), *cert. denied*, 465 U.S. 1052 (1984); *Alabama Farm Bureau Mutual Casualty Co., Inc.* v. *American Fidelity Life Ins. Co.*, 606 F.2d 602, 611 (5th Cir. 1979) (distinguishing between "characterization" and "fact"), *cert. denied*, 449 U.S. 820 (1980); *Golub* v. *PPD Corp.* 576 F.2d 759, 765 (8th Cir. 1978) (plaintiffs had no right to have the proxy statement characterize the transaction "as plaintiffs would have it characterized"); *Goldberg* v. *Meridor*, 567 F.2d 209, 218 n.8 (2d Cir. 1977) (Friendly, J.) (it is not deceptive for a proxy statement to fail to characterize disclosed facts with "pejorative nouns or adjectives"), *cert. denied*, 434 U.S. 1069 (1978); *Klamberg* v. *Roth*, 473 F. Supp. 544, 552 (S.D.N.Y. 1979) (once the objective facts are fairly disclosed, a reasonable person cannot be deceived by the proxy statement's failure to "articulate adverse inferences from or pejorative descriptions of those facts").[7]

Similarly, where subjective characterizations have been used, the courts of appeal have routinely dismissed claims challenging such characterizations where the objective facts have been fully disclosed. *See, e.g.*, *Zerman* v. *Ball*, 735 F.2d 15, 21 (2d Cir. 1984) (alleged characterizations of bonds as "marvelous" are not actionable under the securities laws); *Leslie* v. *Minson*, 679 F. Supp. 280, 285 (S.D.N.Y. 1988) (optimistic characterizations of investments are not actionable under the securities laws); *Biesenbach* v. *Guenther*, 588 F.2d

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7 *See also Nanfito* v. *Tekseed Hybrid Co.*, 341 F. Supp. 240, 245 (D. Neb. 1972), *aff'd*, 473 F.2d 537 (8th Cir. 1973) (Defendants properly informed investors about the reasons for the merger; "[t]hey could not, in this Court's view, be required to go further and analyze the[se] facts . . . ."); *Freeman* v. *Decio*, 584 F.2d 186, 199, 200 (7th Cir. 1978) ("In nondisclosure cases under Rule 10b-5 it has been suggested that 'nondisclosure of predictions will not normally break the Rule' ").

400, 401-402 (3d Cir. 1978) (statement that the proposed transactions "were in the best interests of the shareholders and were designed to protect shareholders' financial interests" are not actionable under the securities laws); *Bulgo* v. *Munoz*, 853 F.2d 710, 716 (9th Cir. 1988) ("an actionable misrepresentation must relate to fact and cannot be based on an expression of opinion"). As the court observed in *Presidio Enterprises, Inc.* v. *Warner Bros. Distributing Corp.*, 784 F.2d 674, 679 (5th Cir. 1986):

> Actions for fraud and misrepresentation must be based on objective statements of fact, not expressions of personal opinion. The law wisely declines to tread in the latter area because . . . 'everyone is entitled to his own opinion' . . . . A statement of fact is one that (1) admits of being adjudicated true or false in a way that (2) admits of empirical verification.

The Second Circuit's decision in the present case departs from these well-established principles, drastically expands the scope of liability under the federal securities laws, and will inevitably create enormous mischief. There can be no end to debates over such issues as whether a right is "valuable" or "illusory", "protective" or "worthless". To subject defendants to draconian financial penalties for using the "wrong" adjective, or for failing to use the "right" one, as decided *post hoc* by a jury, would embroil the federal courts in a swarm of vexatious, pointless litigation. It was precisely to avoid such an eventuality that the courts have uniformly, until now, limited claims under the federal securities laws to disputes concerning objective facts.[8]

Perhaps the clearest example of the mischief that will be created by the opinion below is its holding that the Prospectus may have been misleading by using the term "Independent Director". The Court of Appeals found that the term "Independent" could suggest to a reasonable investor that

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8 Indeed, when the Fourth Circuit in *Virginia Bankshares* recently departed from these principles by finding defendants liable for use of the word "independent", this Court granted certiorari.

the Independent Directors would be independent not only of management but also of the corporation and its shareholders—despite the fact that the definition of "Independent Director" set forth in the Indenture and repeated in the Prospectus, as well as the commonly accepted definition of the term, are flatly inconsistent with any such interpretation. Previous cases construing the disclosure requirements of the federal securities laws have held that the use of the adjective "independent" in analogous contexts is not actionable. *Radol* v. *Thomas*, 534 F. Supp. 1302, 1315 (S.D. Ohio 1982) (description of an investment banking firm as "independent" cannot constitute a material misrepresentation); *Mills* v. *Esmark, Inc.*, 544 F. Supp. 1275, 1295 (N.D. Ill. 1982) (it is "well established that representations concerning the purported independence of a corporate committee are not generally actionable under the securities laws").

This Court should not allow the federal securities laws to degenerate into *post hoc* editorializing and nitpicking over the use of subjective, descriptive phrases where all the objective facts have been disclosed.

II. THE FEDERAL SECURITIES LAWS DO NOT REQUIRE DISCLOSURE OF LEGAL CONCLUSIONS OR GENERAL PRINCIPLES OF LAW

As the dissent below recognizes, it should not be necessary under the federal securities laws to disclose "fundamental principles of corporate governance". The majority opinion, however, necessarily rests on the contrary proposition that under some circumstances it is necessary for defendants to "disclose" to sophisticated financial institutions the proposition that directors owe their fiduciary duties to shareholders, not debentureholders.

Such a requirement is fundamentally inconsistent with authority in other Circuits holding that there is no duty to disclose legal conclusions or to provide advice concerning the legal consequences flowing from disclosed facts. *See Ash* v.

LFE Corp., 525 F.2d 215, 220 (3d Cir. 1975) (securities laws do not require the disclosure of "speculative issues of state corporation law"); *Vohs* v. *Dickson*, 495 F.2d 607, 625 (5th Cir. 1974) ("Rule 10b-5 cannot be construed to require a prospective seller of securities to give his prospective buyers legal advice on technical matters arising under the federal securities law. If the buyer is aware of the material facts . . . he should be as aware of the legal consequences of those facts as his seller"). The decision is also at odds with lower court opinions in the Second Circuit. *Burghart* v. *Landau*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,549 at 93,518 (S.D.N.Y. August 11, 1989) ("All [plaintiff] alleges is that they did not disclose the supposed legal consequences of facts accurately stated. Such a claim is simply not actionable as a matter of law"); *Nemo* v. *Allen*, 466 F. Supp. 192, 195 (S.D.N.Y. 1979) ("All that need be disclosed are the facts from which a stockholder may draw its own conclusion").

As the dissent notes (*id.* at 2962), general principles of corporate governance are public information of which investors are deemed to be aware. *See also Alabama Farm Bureau Mutual Casualty Company Inc.* v. *American Fidelity Life Insurance Company*, 606 F.2d 602, 610 (5th Cir. 1979) (the securities laws do not require the disclosure of "deductions reached from publicly available information"); *Acme Propane, Inc.* v. *Tenexco, Inc.*, 844 F.2d 1317, 1323 (7th Cir. 1988) ("the securities laws require the disclosure of information that is otherwise not in the public domain"); *Seibert* v. *Sperry Rand Corp.*, 586 F.2d 949, 952 (2d Cir. 1978); *Johnson* v. *Wiggs*, 443 F.2d 803, 806 (5th Cir. 1971) (information within public domain need not be disclosed); *Mendell* v. *Greenberg*, 612 F. Supp. 1543, 1551 (S.D.N.Y. 1985).

As noted above, any broadening of the federal securities laws to require inclusion of legal analyses and conclusions would seriously encumber the disclosure process, while providing arcane, hedged, and verbose disclosures which, in view of the inherent uncertainties in the development of the law, would be as likely to mislead as to inform.

III. THE FEDERAL SECURITIES LAWS DO NOT REQUIRE DISCLOSURE OF SPECULATIVE CONCLUSIONS

By imposing a requirement that issuers must disclose whether a debenture right is "valuable" or "illusory", the decision below also runs afoul of the basic principle that parties are not required to disclose speculative predictions as to what may happen in the future. In the present case, there was simply no way for Wherehouse or its directors to know whether any merger proposal would ever be considered; whether such a proposal, if it were made, would be injurious to debentureholders; or whether such a proposal would be likely to be approved or disapproved. Thus, when the Debentures were issued it was simply not possible for anyone to know whether the optional right to tender would ever be triggered, or under what circumstances.

It follows that any discussion about the inherent "value" of this right, or of the likelihood of future director actions under different possible scenarios, would be inherently speculative. As this Court held in *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988), contingencies that are entirely speculative are not material facts and do not have to be disclosed. *See also Flynn* v. *Bass Bros. Enterprises, Inc.*, 744 F.2d 978, 985 (3d Cir. 1984) (as a matter of public policy courts do not require the inclusion of projections in proxy materials); *Panter* v. *Marshall Field & Co.*, 646 F.2d 271, 292 (7th Cir 1981) (same), *cert. denied*, 454 U.S. 1092 (1981); *Rodman* v. *Grant Foundation*, 608 F.2d 64, 72 (2d Cir. 1979) ("[f]ull factual disclosure need not be embellished with speculative financial predictions"); *In Re Craftmatic Securities Litigation*, 703 F. Supp. 1175, 1179 (E.D. Pa. 1989) (companies are not required to make future-oriented projections); *Hecco Ventures* v. *Avalon Energy Corp.*, 606 F. Supp. 512, 519 (S.D.N.Y. 1985) ("the material facts were disclosed, and the parties had no obligation to offer additional speculations"); *Billard* v. *Rockwell Int'l Corp.*, 526 F. Supp. 218, 221 (S.D.N.Y. 1981) ("matters of prediction or speculation" need

not be disclosed; "securities laws require only 'the disclosure of basic facts so that [others] may draw upon their own valuative expertise' "), *aff'd*, 683 F.2d 51 (2d Cir. 1982).

Moreover, it is far from clear that debentureholders would benefit from a Prospectus that speculated about all the potential scenarios that could arise and how the Independent Directors would respond to them. *See TSC Industries* v. *Northway, Inc.*, 426 U.S. 438, 448-49 (1976) (warning that excessive exposure to liability will cause management to "bury the shareholders in an avalanche of trivial" and distracted information—"a result that is hardly conducive to informed decision making"). Once the objective material facts are disclosed, no goal of investor protection is served by requiring directors to speculate about potential transactions and how the corporation might react to them.

CONCLUSION

For the reasons stated above, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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August 1990

APPENDIX

Opinion of the United States Court of Appeals
For the Second Circuit

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 399—August Term 1989

Argued: December 19, 1989 Decided: April 10, 1990

Docket No. 89-7664

MCMAHAN & COMPANY, FROLEY, REVY INVESTMENT CO., INC. and WECHSLER & KRUMHOLZ, INC.,

Plaintiffs-Appellants,

—against—

WHEREHOUSE ENTERTAINMENT, INC., LOUIS A. KWIKER, GEORGE A. SMITH, MICHAEL T. O'KANE, LAWRENCE K. HARRIS, DONALD E. MARTIN, JOEL D. TAUBER, FURMAN SELZ MAGER DIETZ & BIRNEY, INC., WEI ACQUISITION CORP., WEI HOLDINGS, INC., ADLER & SHAYKIN, and CHEMICAL BANK,

Defendants-Appellees.

Before:

OAKES, PRATT, *Circuit Judges*, and
LEONARD B. SAND, United States District Judge
for the Southern District of New York,
sitting by designation.

Plaintiffs appeal from summary judgment of United States District Court for Southern District of New York, Mary Johnson Lowe, *Judge*, dismissing complaint charging securities violations based on misrepresentation in debenture offering.

Reversed and remanded. Judge Sand dissents in a separate opinion.

PHILIP K. HOWARD, New York, NY (Howard, Darby & Levin, Warren G. Caywood, Jr., Bonnie Blacklock, of Counsel), *for Appellant McMahan*.

DENNIS J. BLOCK, New York, NY (Weil, Gotshal & Manges, H. Adam Prussin, Richard B. Friedman, Miranda S. Schiller, of Counsel), *for Appellee Wherehouse*.

PRATT, *Circuit Judge*:

Plaintiffs appeal from a judgment of the United States District Court for the Southern District of New York, Mary Johnson Lowe, *Judge*, dismissing their complaint that defendants made material misrepresentations and omissions in a debenture offering in violation of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j; § 11 of the Securities Act of 1933, 15 U.S.C. § 77k; and § 12(2) of the Securities Act of 1933, 15 U.S.C. § 77*l*. Finding that the complaint "fail[ed] to

allege any omission or misstatement of fact—material or otherwise—within the meaning of the securities laws", the district court granted summary judgment to defendants. The court also dismissed plaintiffs' state-law claims for lack of pendent jurisdiction. Since we conclude that plaintiffs presented sufficient evidence to create a genuine issue as to whether the offering was materially misleading, we reverse the summary judgment and remand the case for further proceedings.

BACKGROUND

Defendant Wherehouse Entertainment, Inc. offered 6-1/4% convertible subordinated debentures whose key selling feature was a right of holders to tender the debentures to Wherehouse in the case of certain triggering events which might endanger the value of the debentures. The tender right was to arise if:

> (a) A person or group * * * shall attain the beneficial ownership * * * of an equity interest representing at least 80% of the voting power * * * unless such attainment has been approved by a majority of the Independent Directors;
>
> (b) The Company * * * consolidates or merges * * * unless approved by a majority of the Independent Directors;
>
> (c) The Company * * * incurs * * * any Debt * * * excluding * * * Debt which is authorized or ratified by a majority of the Independent Directors, immediately after the incurrence of which the ratio of the Company's Consolidated Total Debt to its Consolidated Capitalization exceeds .65 to 1.0.

Indenture § 5.02, 11-12 (June 15, 1986); *see also* Prospectus *Summary*, "Optional Tender", 3 (July 10, 1986); *id. Description of Debentures*, "Optional Debenture Tender", 25-26.

The offering materials defined an "Independent Director" as "a director of the Company" who was not a recent employee but who was a member of the board of directors on the date of the offering or who was subsequently elected to the board by the then-Independent Directors. Indenture, § 5.02, 12; Prospectus *Description of Debentures*, "Optional Debenture Tender", 26. The reason offered for this unusual right to tender was that it would be a protection against certain forms of takeover attempts, including leveraged buy-outs. Prospectus *Description of Debentures*, "Effect on Certain Takeovers", 27. At the heart of this appeal is the meaning of the limitation placed on the right to tender by the role of "Independent Directors".

Plaintiffs are financial institutions that purchased 34% of the convertible debentures. Eighteen months after the purchase, Wherehouse entered into a merger agreement with defendants WEI Holdings, Inc. and its subsidiary WEI Acquisition Corp. The practical effect of the merger, accomplished through a leveraged buy-out, left Wherehouse with a debt approaching 90% of its capitalization and left plaintiffs' debentures valued at only approximately 50% of par. Plaintiffs attempted to exercise their right to tender, but the company refused to redeem the debentures on the ground that the "board of directors" had approved the merger. Plaintiffs then commenced this suit for damages and an injunction to prevent the merger. Named as defendants were Wherehouse, various officers of Wherehouse, the underwriter

of the debentures, WEI Holdings, Inc., WEI Acquisition Corp., and the bank that was financing the tender offer. Plaintiffs claimed that the descriptions of the debentures in the registration materials, as well as representations made during conversations, were materially misleading. Specifically, they claimed that, even though the defendants knew that the right to tender was illusory, their representations of the right as valuable and protected had misled investors into buying the debentures and therefore violated federal securities laws. In the alternative, claiming that the representations created a right to tender under the contract, plaintiffs asserted state-law claims of breach of contract, interference with contract, breach of implied duty of good faith, and fraudulent conveyance.

Defendants argued that all the relevant provisions were clear and unambiguous and that no false statements were made; thus the offering was not materially misleading or in violation of the securities laws.

The district court found nothing misleading. It granted summary judgment to defendants and dismissed plaintiffs' state-law claims for lack of pendent jurisdiction. The district court held that defendants were not required to speculate about the likelihood of a waiver of debentureholders' rights by the Independent Directors and that, even if the right were worthless, defendants were not required to use pejorative terms describing it as such. Moreover, it found the tender option was not illusory, because it (was possible that it) might provide a benefit to debentureholders in the case of a takeover hostile to shareholders which management chose to fight. Finally, according to the district court, the definition of "Independent Directors" was adequate because

further description of their role, the extent of their discretion, their interests, or their intent would constitute mere legal conclusions, characterizations, or descriptions of underlying motives and were not required disclosures. Thus, the district court found that the descriptions of the right were not misstatements, and that the alleged omissions were not required to be disclosed under the securities laws.

We disagree with the district court's atomistic consideration of the presentation of the debentureholders' right to tender. The district court concluded that defendants had not misled plaintiffs because the information they included in the written and oral representations was "literally true". We think, however, that when read as a whole, the defendants' representations connoted a richer message than that conveyed by a literal reading of the statements. The central issue on all three claims is not whether the particular statements, taken separately, were literally true, but whether defendants' representations, taken together and in context, would have mislead a reasonable investor about the nature of the debentures.

Some statements, although literally accurate, can become, through their context and manner of presentation, devices which mislead investors. For that reason, the disclosure required by the securities laws is measured not by literal truth, but by the ability of the material to accurately inform rather than mislead prospective buyers. *Greenapple v. Detroit Edison Co.*, 618 F.2d 198, 205 (2d Cir. 1980) (where method of presentation or "gloss" placed on information obscures or distorts significance of material facts, it is misleading). Even " 'a statement which is literally true, if susceptible to quite another interpretation by the reasonable investor • • •

may properly * * * be considered a material misrepresentation.' " *Beecher v. Able*, 374 F. Supp. 341, 347 (S.D.N.Y. 1974) *quoting SEC v. First American Bank & Trust Co.*, 481 F.2d 673 (8th Cir. 1973).

We hold that the district court erred in granting summary judgment to the defendants; because plaintiffs have raised a triable issue as to whether the written and oral representations about the right to tender these debentures were materially misleading to a reasonable investor in violation of § 11 and § 12 of the 1933 Securities Act and also of § 10(b) of the 1934 Securities Exchange Act. Since the analysis for all three securities claims is similar, we will first consider it in some detail under § 11, and then review it only briefly under §§ 12 and 10(b).

A. *Section 11 of the Securities Act of 1933*

Section 11 states that any signer, officer of the issuer, and underwriter may be held liable for a registration statement which "contained an untrue statement of a material fact or omitted to state a material fact * * * necessary to make the statements therein not misleading". Plaintiffs claim that these offering materials misstated the right to tender and omitted important information about it in violation of § 11. They argue that a reasonable investor would have believed that the right to tender was valuable because it was presented as a right to be exercised at the holder's option and as a protection against takeovers that might affect the security of the debentures. In truth, however, the right to tender was illusory, they argue, because it was designed to be exercised only at the option of management and

therefore was intended to protect the interests of shareholders, not of debentureholders.

Plaintiffs are correct that the offering materials can reasonably be read to present the option to tender as a valuable right. The language used was invariably language of entitlement:

> *Holder's Right to Tender*. The Holder of any Security or Securities shall have *the right, at his option*, * * * *to tender* for redemption any such Security or Securities.

Indenture § 5.01, 10 (emphasis added). The prospectus summary provided that:

> "Each holder of Debentures has the *option to require* the Company to redeem the holder's Debentures."

"Optional Tender", 3 (emphasis added). And the prospectus itself stated:

> "Holders of the Debentures *will have the option* * * * *to require* the Company to redeem such Debentures."

Description of Debentures, "Optional Debenture Tender", 25 (emphasis added).

Further, a jury could reasonably view the presentation of the right to tender as a special feature to protect investors, for the offering materials stressed the purported value of the right in any takeover transaction which would threaten the value of the debentures.

> Since the events which give rise to such right of redemption could be expected to occur in connection with certain forms of takeover attempts, the

> optional tender provisions could deter takeovers where the person attempting the takeover views itself as unable to finance the redemption of the principal amount of Debentures which may be tendered * * * To the extent that Debentures may be tendered * * * the Company would be unable to use the financing provided by the sale of the Debentures offered hereby. In addition, the ability of the Company to obtain additional Senior Debt based on the existence of the Debentures would be similarly adversely affected.

Prospectus *Description of Debentures*, "Effect on Certain Takeovers", 27; *see also id.* "Optional Debenture Tender", 26.

Finally, the right was restricted only in that it was subject to action by "the Independent Directors". Similar language describing the restriction—the right to tender occurs upon a triggering event, "*unless* [the event is] approved by a majority of the Independent Directors" (emphasis added)—is found in the Indenture, § 5.02, 11-12; in the prospectus summary, "Optional Tender", 3; and again in the full prospectus, *Description of Debentures*, "Optional Debenture Tender", 25-26. A jury could reasonably find that this repeated use of the word "unless" encouraged the inference that exercise of the right would be the norm and that waiver would be the exception.

Although the offering materials explain that the Independent Directors would be chosen from the company's board of directors, the term "Independent Director" implies a special status, some distinction from an "ordinary" director. The term suggests that these directors would be "independent" of management and the nor-

mal obligations of board members to act in the interests of shareholders. Thus the restriction could reasonably be understood to mean that in the case of a triggering event, the right to tender would arise *unless* the Independent Directors find the event to be in the interests of the debentureholders. In short, as plaintiffs argue, a reasonable investor could have regarded the right to tender as a valuable right, protected by Independent Directors who would, in situations endangering the security of the debentures, consider debentureholders' interests before approving any waiver of their right.

By thus representing that in a takeover context the Independent Directors would be considering the interests of debentureholders, the defendants implied that the Independent Directors had a duty to protect the debentureholders' interests. Defendants, however, have shown nothing in their corporate charter or by-laws that would have permitted, much less required, these Independent Directors to favor debentureholders over shareholders. Moreover, at the time of the approval of this merger, the Independent Directors constituted all but one of the "ordinary" directors on the board. As ordinary directors, they had a fiduciary duty to protect the interests of shareholders in any takeover situation, regardless of debentureholders' interests or rights. It is inevitable, then, that the so-called Independent Directors had no independence; they would never protect the interests of debentureholders except by coincidence because, as ordinary directors, they were required by law to protect the interests of the shareholders. From this perspective, there is merit in plaintiffs' contentions that the right to tender was illusory and that the representations of it in the offering materials were misleading.

In sum, on a fair reading of the offering materials, despite their literal meaning, an investor could have reasonably believed that the tender option was presented as a valuable right for debentureholders; that it provided a special feature of protection for their interests; and that Independent Directors were to render independent votes on the right to tender based on the impact of a merger and on the interests of debentureholders. But if, as plaintiffs claim, the right to tender was illusory because the Independent Directors were tied to management, served its needs, protected shareholders' interests, and would inevitably waive the right in any merger beneficial to management regardless of debentureholders' interests, then the offering materials could be found by a rational trier of fact to be materially misleading in violation of § 11 of the Securities Act of 1933. Plaintiffs have therefore raised a genuine issue as to whether the written representations could have misled a reasonable investor, *Greenapple*, 618 F.2d at 205, and summary judgment was therefore unwarranted.

B. *Section 12 of the Securities Act of 1933*

Section 12(2) of the Securities Act of 1933 presents a problem similar to § 11, but it has the added factor of oral representations made to the investors in order to induce them to purchase. Section 12(2) states that anyone who makes a securities offering "by means of a prospectus *or oral communication*, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements * * * not misleading * * * shall be liable" (emphasis added). In an affidavit, Thomas Revy of plaintiff Froley, Revy, alleges that in a phone conversation and at a "due diligence" lunch, officers of Wherehouse specifi-

cally represented that the debentures included the right to tender as a "protective covenant for the debentureholders" against takeovers. Plaintiffs claim these oral communications were untrue and violated § 12(2).

Defendants argue that the statements were accurate because they would protect holders in the event of a takeover that was hostile to management. The district court agreed, finding that "where the company might find itself subjected to an hostile takeover, the right to tender could, indeed, be 'protective' of the debentureholders' interests."

However, the language used—"protective covenant" and "special protection"—is promissory and unrestricted. The statements clearly imply that the protection to debentureholders would extend to the case of any takeover hostile to the holders' rights. It would be, to say the least, a cramped interpretation to view the right to tender as a "protective covenant for the debentureholders" if its protection were limited to a takeover that was hostile only to management and the shareholders. Finally, by representing that this special right to tender was the key selling feature of other wise low-value debentures, defendants could be found to have implied that debentureholders would be protected against takeovers hostile to their own interests, regardless of the interests of shareholders, and thus to have misled plaintiffs as to the true nature of the right. Summary judgment was therefore inappropriate on plaintiffs' § 12(2) claim.

C. *Section 10(b) of the Securities Exchange Act of 1934*

Section 10(b) of the Securities Exchange Act of 1934, the general fraud provision of the act, prohibits any per-

son from using or employing "any manipulative or deceptive device" in connection with the sale of a security. To state a claim under this section, plaintiffs "must allege material misstatements or omissions indicating an intent to deceive or defraud in connection with the purchase or sale of a security." *Luce v. Edelstein*, 802 F.2d 49, 55 (2d Cir. 1986); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). Plaintiffs claim that disclosure of the true nature of the tender provision not only would have altered a reasonable investor's investment decision, but would have dissuaded investment here by showing these debentures to be a poor risk. They allege that Wherehouse knew this and so deliberately misrepresented the right-to-tender feature, thereby misleading investors in violation of § 10(b).

The district court, having dismissed the claims under § 11, found it was therefore impossible to state a § 10(b) claim. Since we have concluded that a question of fact is presented as to whether the offering materials and the oral communications, taken together, could have misled a reasonable investor, it follows that a jury should also determine whether the defendants violated of § 10(b).

D. *Pendent Claims*

Since the only reason for the district court's dismissing plaintiff's pendent state-law claims was that the federal basis for jurisdiction had disappeared, now that we have reinstated the federal claims, the pendent claims are reinstated as well.

Reversed and remanded.

SAND, *District Judge*:

The reasons why I am constrained to dissent may be briefly stated.

The question whether an anti-takeover provision provides a "special protection" to debentureholders cannot be answered in the negative merely because the "Independent Directors" decided to waive its provisions and approve a particular transaction. These directors were explicitly empowered to act in this fashion by virtue of the fully disclosed terms of the provision. A significant function of an anti-takeover provision is to serve as a deterrent to hostile takeovers, including takeovers which would be contrary to the interests of both shareholders and debenture-holders. One cannot, I believe, fairly characterize such a provision as being "worthless" to the debentureholders, even though as a matter of Delaware law directors owe a fiduciary duty solely to shareholders. The anti-takeover provision was therefore a "special protection" to debentureholders, albeit a limited one.

Federal securities laws do not impose an obligation to advise investors of the fundamentals of corporate governance. The disclosure required by the federal securities laws is not a "rite of confession or exercise in common law pleading. What is required is the disclosure of material objective factual matters." *Data Probe Acquisition Corp. v. Data Lab, Inc.*, 722 F.2d 1, 5-6 (2d Cir. 1983), *cert. denied*, 415 U.S. 1052 (1984). Especially is this so where, as here, the investor-complainants are sophisticated financial institutions making major investments. The role of the federal securities laws is not to remedy all perceived injustices in securities transactions. Rather,

as invoked in this case, it proscribes only the making of false and misleading statements or material omissions.

Whether the Independent Directors breached an implied duty of good faith or otherwise acted contrary to their fiduciary obligations are matters of state law. Here, the federal claims were asserted only conditionally, the express condition being the failure of the state law claims. These state claims were properly dismissed by the court below for lack of pendent jurisdiction.

Believing no valid federal claim to be present, I would affirm essentially for the reasons set forth in the Opinions of the Magistrate and District Court.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Docket No. 89-7664

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the tenth day of April, one thousand nine hundred and ninety.

Present: HON. JAMES L. OAKES, Ch.J.
HON. GEORGE C. PRATT, C.J.
HON. LEONARD B. SAND, D.J.*

Circuit Judges,

MCMAHAN & COMPANY, FROLEY, REVY INVESTMENT CO., INC., and WECHSLER & KRUMHOLZ, INC.,

Plaintiffs-Appellants,

—against—

WHEREHOUSE ENTERTAINMENT, INC., LOUIS A. KWIKER, GEORGE A. SMITH, MICHAEL T. O'KANE, LAWRENCE K. HARRIS, DONALD E. MARTIN, JOEL D. TAUBER, FURMAN SELZ MAGER DIETZ & BIRNEY, INC., WEI ACQUISITION CORP., WEI HOLDINGS, INC., ADLER & SHAYKIN, and CHEMICAL BANK,

Defendants-Appellees.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK.

* Hon. Leonard B. Sand, U.S. District Judge, for the Southern District of New York, sitting by designation.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the Judgment of said District Court be and it hereby is reversed and the action be and it hereby is remanded to the said District Court for further proceedings in accordance with the opinion of this Court with costs to be taxed against the appellees.

ELAINE B. GOLDSMITH
Clerk

By: /s/ EDWARD J. GUARDARO
EDWARD J. GUARDARO
Deputy Clerk

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Docket No. 89-7664

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the 16th day of May one thousand nine hundred and ninety.

Present: Hon. James L. Oakes, Chief Judge,
Hon. George C. Pratt, Circuit Judges.
Hon Leonard B. Sand, District Judge.

Circuit Judges,

MCMAHAN & COMPANY, FROLEY, REVY INVESTMENT CO., INC. and WECHSLER & KRUMHOLZ, INC.,

Plaintiffs-Appellants,

—v.—

WHEREHOUSE ENTERTAINMENT, INC., LOUIS A. KWIKER, GEORGE A. SMITH, MICHAEL T. O'KANE, LAWRENCE K. HARRIS, DONALD E. MARTIN, JOEL D. TAUBER, FURMAN SELZ MAGER DIETZ & BIRNEY INC., WEI ACQUISITION CORP., WEI HOLDINGS, INC., ADLER & SHAYKIN, and CHEMICAL BANK,

Defendants-Appellees.

A petition for a rehearing having been filed herein by Appellees WHEREHOUSE ENTERTAINMENT, INC. ET AL.

Upon consideration thereof, it is Ordered that said petition be and it hereby is DENIED.

Elaine B. Goldsmith,
Clerk

Opinion and Order

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

88 Civ. 0321 (MJL)

MCMAHAN & COMPANY, FROLEY, REVY INVESTMENT CO., INC., and WECHSLER & KRUMHOLZ, INC.,

Plaintiffs,

—against—

WHEREHOUSE ENTERTAINMENT, INC., LOUIS A. KWIKER, GEORGE A. SMITH, MICHAEL T. O'KANE, LAWRENCE K. HARRIS, DONALD E. MARTIN, JOEL D. TAUBER, FURMAN SELZ MAGER DIETZ & BIRNEY INCORPORATED, WEI ACQUISITION CORP., WEI HOLDINGS, INC., ADLER & SHAYKIN, and CHEMICAL BANK,

Defendants.

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MARY JOHNSON LOWE, D.J.

Before this Court are defendants' motions to dismiss the plaintiffs' Revised Amended Complaint ("Complaint") pursuant to Fed.R.Civ.P. 12(b)(1), for lack of subject matter jurisdiction, and 12(b)(6), for failure to state a claim upon which relief can be granted. The motions were referred to Magistrate Roberts on March 21, 1988 for a Report and Recommendation ("R & R"). On notice to the parties, the Magistrate thereafter converted the asserted claims into a motion for summary judgment pursuant to Fed.R.Civ.P. 56. For the reasons set forth below, we adopt the reasoning of the Magistrate's R & R and dismiss Counts Three, Four and Five of plaintiffs' Complaint, which allege various violations of the federal securities laws, pursuant to Fed.R.Civ.P. 56. The remaining state law claims are dismissed for lack of subject matter jurisdiction pursuant to Fed.R.Civ.P. 12(b)(1).

BACKGROUND

This action revolves around a merger agreement between defendant Wherehouse Entertainment, Inc. ("Wherehouse") and defendants WEI Holdings, Incorporated ("Holdings") and its subsidiary WEI Acquisition Corporation ("Acquisition"). Wherehouse is a Delaware corporation which owns and operates record stores in the western United States. Complaint at ¶ 9. Acquisition and Holdings are both Delaware corporations with their principal places of business in New York City. Holdings is owned by defendant Adler & Shaykin ("A & D"), a partnership also located in New York City. *Id.*

at ¶ 17. Also named as defendants are Louis A. Kwiker ("Kwiker"), Wherehouse's Chief Executive Officer, President and director; George A. Smith, Michael T. O'Kane, Lawrence K. Harris, Donald E. Martin, and Joel D. Tauber (collectively the "Independent Directors"), all of whom are directors of defendant Wherehouse, *Id.* at ¶¶ 10-16; Furman Selz Mager Dietz & Birney, Incorporated ("Furman Selz"), a corporation which purportedly acted as advisor to Wherehouse in negotiating the merger and underwrote the debentures at issue in this action *Id.* at ¶ 50; and Chemical Bank ("Chemical"), a New York banking corporation which agreed to provide the financing for the tender offer which led to Acquisition's eventual merger into Wherehouse. *Id.* at ¶ 19.

The plaintiffs McMahan & Company ("McMahan"), Froley, Revy Investment Company, Incorporated ("Froley Revy"), and Wechsler & Krumholz, Incorporated ("W & K") are financial institutions which hold thirty-four percent of Wherehouse's convertible debentures. As debentureholders, and pursuant to the terms of the governing Indenture, plaintiffs were provided with a "right to tender" the debentures to Wherehouse at their principal amount, along with a specified amount in the early years. As the plain language of the Indenture makes clear, however, this right to tender was not absolute. Rather, the right was conditioned upon the occurrence of certain "triggering" events, namely when:

> (a) A person or group . . . shall attain the beneficial ownership . . . of an equity interest representing at least 80% of the voting power for election of the Board of Directors of the Company *unless such attainment has been approved by a majority of the Independent Directors*; [or]
>
> (b) The Company . . . consolidates or merges with any other person . . . *unless approved by a majority of the Independent Directors*; [or]
>
> (c) The Company or any Subsidiary incurs, issues, assumes, guarantees or creates any Debt, or pledges any Company or Subsidiary assets to secure repay-

> ment of any Debt, *excluding* Debt existing on July 9, 1986 and *Debt which is authorized or ratified by a majority of the Independent Directors.*

Indenture between Wherehouse and Bank of America National Trust and Savings Association ("Indenture"), § 5.02 (emphasis supplied). As the language of this provision also makes clear, the "triggering" effect of the three specified events was, itself, conditioned upon the number of directors approving the underlying transaction. The prospectus, pursuant to which the debentures were advertised, essentially recites *verbatim* the Indenture's description of the right to tender.

As it so happened, the merger at the core of this action was unanimously approved, with one director abstaining, by Wherehouse's Board of Directors. Consequently, plaintiffs' right to tender, which, plaintiffs contend, would have allowed them to redeem the debentures at 106.25% of par, Complaint at ¶ 26, was never triggered. Instead, as plaintiffs allege, the practical effect of the merger—which was accomplished through a leveraged buy-out—left Wherehouse with a debt approaching 90% of its capitalization and left plaintiffs with debentures approximately valued at only 50% of par. *Id.* The gravamen of the present complaint, which followed on the heels of the Wherehouse merger, is that plaintiffs were never made aware that the Independent Directors, without so much as considering the interests of the debentureholders, had the unbridled discretion to approve any one of the specified triggering events and thereby waive plaintiffs' right to tender. Alternatively, plaintiffs argue under state law that the Independent Directors did, indeed, have a contractual obligation to act in the best interests of the debentureholders when approving (or disapproving) any of the triggering events.

On January 15, 1988, plaintiffs commenced the present action alleging, under state law, breach of contract, breach of implied duty of good faith and fair dealing, intentional interference with a contract, and fraudulent conveyance. Only three counts in plaintiffs' Complaint allege causes of action under federal law and, as the R & R indicates, all three are

made expressly conditional on the failure of plaintiffs' claims under state law. R & R at 8. Specifically, Count Three of the Complaint alleges that the prospectus for the debentures, dated July 10, 1986, contained material misstatements and omissions in violation of § 11 of the Securities Act of 1933, 15 U.S.C. § 77k, because it "nowhere suggests that the right to tender is not intended for the benefit of the debentureholders . . . [or] . . . that the Independent Directors may waive the right in a situation where the triggering events adversely affect debentureholders." *Id.* at ¶ 35.

Count Four alleges that defendant Furman Selz, on two occasions, made materially false and misleading statements in connection with the sale of the debentures, in violation of Section 12(2) of the Securities Act of 1933, 15 U.S.C. § 771, when it represented to Thomas Revy, a principal of plaintiff Froley, Revy, that the debentures included a " "special protection for debentureholders" in the event that the Company [Wherehouse] was subject to a takeover," *Id.* at ¶ 42, and a " "protective covenant for the debentureholders" to protect against takeovers." *Id.* at ¶ 43. Plaintiffs contend that in view of these oral representations and the aforementioned statements in the prospectus, "the failure to state that the right to tender could be eliminated in the unrestricted discretion of a majority of the directors constituted an omission to state a material fact necessary in order to make statements made, in light of the circumstances, not misleading." *Id.* at ¶ 46.

Finally, Count Five of the Complaint alleges that the defendants,[1] in violation of § 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j, knowingly or recklessly omitted to state in the registration statements and prospectus "that neither the Company [Wherehouse] nor the Directors had any intention of making the determination whether to waive the right to tender from the standpoint of the debentureholders." *Id.* at ¶ 51.

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1 It should be noted that the only claim asserted against defendant—Chemical Bank is under state law for fraudulent conveyance. *Id.* at ¶ 57.

On February 23, 1988, all of the defendants, with the exception of Chemical Bank, moved to dismiss plaintiffs' complaint pursuant to 12(b)(1) and 12(b)(6) of the Federal Rules of Civil Procedure. On February 29, 1988, defendant Chemical Bank also moved for dismissal under Fed.R.Civ.P. 12(b)(1). As previously noted, the motions were referred to on March 21, 1988. The parties were thereafter advised of Magistrate Robert's intention to treat the 12(b)(6) motion to dismiss as a motion for summary judgment pursuant to Fed.R.Civ.P. 56. Before this Court is the Magistrate's recommendation that summary judgment be granted in favor of the defendants on all of the federal securities claims alleged and that the remaining state law claims be dismissed for lack of subject matter jurisdiction.

DISCUSSION

Summary judgment is appropriate where "there is no genuine issue as to any material fact and . . . the moving party is entitled to judgment as a matter of law." Fed.R.Civ.P. 56(c). As the R & R indicates, summary judgment is generally inappropriate in federal securities cases where the materiality of the alleged misstatement or omission is at issue. R & R at 16. Materiality is a mixed question of law and fact and unless the alleged misstatements or omissions are "so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance," a motion pursuant to Fed.R.Civ.P. 12(b)(6) or 56 should be denied. *Goldman v. Belden*, 754 F.2d 1059 (2d Cir. 1985). The basis for the Magistrate's recommendation that plaintiffs' federal securities claims be dismissed was not, however, her judgment that the alleged omissions and misstatements were immaterial or negligible. Rather, her recommendation was based upon the conclusion that plaintiffs had failed to allege any omission or misstatement—material or otherwise—within the meaning of the federal securities laws.[2] Consequently,

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2 Accordingly, plaintiffs' contention that "[i]t was clear error . . . for the Magistrate to conclude as a matter of law that these omissions are not

there was no need to address the more complicated issue of materiality. R & R at 16-17.

The Magistrate's analysis was premised upon the view that the disclosure required by the federal securities laws "is not a rite of confession or exercise in common law pleading. What is required is the disclosure of *material objective factual matters.*" *Data Probe Acquisition Corp. v. Datatab, Inc.*, 722 F.2d 1, 5-6 (2d Cir. 1983), *cert. denied*, 465 U.S. 1052 (1984) (emphasis supplied). The courts of this Circuit have interpreted those laws to require "nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative experience in reaching their own investment decisions." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969); *see also Gulf & Western Industries, Inc. v. Great Atlantic & Pacific Tea Co., Inc.*, 476 F.2d 687, 697 (2d Cir. 1973). On the other hand, the disclosure requirements, no matter how broadly construed, do not compel parties, such as the defendants here, to set forth legal conclusions, *Koppel v. Wien*, 575 F.Supp. 960, 968 (S.D.N.Y. 1983), engage in speculation, *Hecco Ventures v. Avalon Energy Corp.*, 606 F.Supp. 512, 519 (S.D.N.Y. 1985), characterize the basic underlying facts with pejorative descriptions or verbalize all adverse inferences expressly. *Klamberg v. Roth*, 473 F.Supp. 544, 551-52 (S.D.N.Y. 1979). In short, the securities laws upon which plaintiffs' claims are premised do not require corporations "to address their stockholders [or other investors] as if they were children in kindergarten." *Richland v. Crandall*, 262 F.Supp. 538, 554 (S.D.N.Y. 1967).

With these basic precepts in mind, we now turn to the specific claims as set forth in the Complaint and as elaborated upon in the accompanying affidavits. For the purposes of her analysis, the Magistrate examined Count Three, under § 11

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material," Plaintiffs' Objections to the Magistrate's Report and Recommendation ("Objections") at 15, plainly misconceives the thrust of the Magistrate's R & R.

of the Securities Act of 1933,[3] and Count Five, under § 10(b) of the Securities Exchange Act of 1934,[4] together. This Court concurs in that analytical approach, not simply because the relevant portions of both provisions impose civil liability for material omissions in virtually identical language,[5] but also because the omissions alleged in both counts are, themselves, virtually identical. Count Three alleges at various portions that the prospectus was materially misleading because it nowhere "suggests that the Independent Directors may waive the right [to tender] in a situation where the triggering events adversely affect debentureholders" and nowhere "discloses that the Independent Directors' fiduciary duties to the Company's shareholders might conflict and interfere with the debentureholders' contractual right to tender." Complaint at ¶ 35. Count Five similarly alleges that defendants willfully

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3 Section 11 provides in relevant part:

(a) In case any part of the registration statement . . . contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security . . . may . . . sue—

(1) every person who signed the registration statement;

(2) every person who was a director . . . or partner in the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted.

4 Section 10(b) provides, in relevant part:

It shall be unlawful for any person, . . . by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

5 *See Rubin v. Long Island Lighting Co.*, 576 F.Supp. 608, 612 (E.D.N.Y. 1984) (both provisions "stand or fall together," because liability under both is premised on the making—in a registration statement or prospectus—of a material misstatement or omission. However, section 10(b) does require, in addition, a showing of scienter.)

omitted to state in the registration statement and prospectus that "neither the Company nor the Directors had any intention of making the determination whether to waive the right to tender from the standpoint of the debentureholders." *Id.* at ¶ 51.

The essence of plaintiffs' grievance under both of these counts is that plaintiffs were never informed that the conditional right to tender did *not* carry with it something in the way of a fiduciary obligation on the part of the directors to act in the best interests of the debentureholders. Indeed, as the Complaint makes plain, the success of these federal claims is predicated upon the very failure of plaintiffs' claims under state law which allege, conversely, that the right to tender did, in fact, give rise to such a contractual fiduciary duty. The thrust of plaintiffs' argument thus appears to be that if, under state law, no fiduciary duty on the part of the directors existed, then the defendants, under the federal securities laws, were obligated to so inform the plaintiffs.

We agree with the Magistrate that statements of this nature would amount to legal conclusions and characterizations which, under the federal securities laws, defendants were in no way obligated to provide. R & R at 19-20; *see Koppel*, 575 F.Supp. at 968. Indeed, in faulting the Prospectus for "assum[ing], among other things, legal knowledge (both as a matter of contract interpretation and corporate law), that the so-called "Independent Directors" owed no duty to the debentureholders," plaintiffs' Objections to the R & R underscore the very legal nature of the characterizations they claim the defendants were obligated to make. Objections at 6 ("Nor does it [the prospectus] explain that the fiduciary duties of the so-called "Independent Directors" are owed solely to the company's shareholders, not the debentureholders"). *See also Id.* at 17-18 ("Here . . . the company refused to disclose the known legal effect of the debentureholders' alleged right to tender . . .").[6]

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6 To the extent plaintiffs' allegation in Count Five might be distinguished from the allegations in Count Three to mean that defendants deliber-

Plaintiffs' further allegation in Count Three and Five that neither the prospectus nor Wherehouse and/or its directors disclosed that the right to tender "*might* be illusory," suffers from similar deficiencies. Complaint at ¶¶ 36 and 48 (emphasis supplied). While plaintiffs' right to tender may not have been, from plaintiffs' point of view, "worth a bucket of warm spit"[7] because "over 90% of all acquisitions (including hostile takeovers) are conducted with the agreement of the pre-existing directors,"[8] the federal securities laws by no means require the basic underlying facts of plaintiffs' right to tender to be cast in such pejorative terms. *Goldberg v. Meridor*, 567 F.2d 209, 218 n.8 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978) (Section 10(b) does not require transactions to be characterized by pejorative nouns or adjectives); *Klamberg*, 473 F.Supp. at 551-52.

At any rate, required disclosure of the operational value of the right to tender, with or without the pejorative characterizations, would have compelled the defendants in the instant case to speculate, not merely upon the number of triggering events likely to be forthcoming, but also upon the likelihood that those prospective events would be approved by a majority of the Independent Directors. As previously noted, the federal securities laws do not go so far as to affirmatively mandate predictions on the part of issuers, particularly predictions of this magnitude. *Hecco Ventures*, 606 F.Supp. at 519 ("the material facts were disclosed, and the parties had no obligation to offer additional speculation . . . "); The

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ately misled plaintiffs into thinking they would act in a fiduciary capacity, while, all along, defendants never intended to so act, the allegation must nevertheless be dismissed for failure to state a claim. As this Circuit has noted previously, while the "making [of] a specific promise to perform a particular act in the future while secretly not intending to perform that act may violate Section 10(b) where the promise is part of the consideration . . . [s]uch a promise . . . must encompass particular actions and be more than a generalized promise to act as a faithful fiduciary." *Luce v. Edelstein*, 802 F.2d 49, 55 (2d Cir. 1986); *see also Pross v. Katz*, 784 F.2d 455, 457-58 (2d Cir. 1986).

7 Letter to the Court dated November 3, 1988.

8 Letter to the Court dated June 14, 1988.

extent of the benefit provided by the right to tender was a determination which plaintiffs, cognizant of the basic underlying facts and drawing upon their own evaluative experience, should have made for themselves. The securities laws do not require issuers to make such forecasts for them.[9] *Billard; v. Rockwell International Corp.*, 526 F.Supp. 218, 221 (S.D.N.Y. 1981) ("matters of prediction or speculation" need not be disclosed; "securities laws require only the disclosure of basic facts so that [others] may draw upon their own evaluative expertise"), *aff'd*, 683 F.2d 51 (2d Cir. 1982); *Straus v. Holiday Inns, Inc*, 460 F.Supp. 729 (S.D.N.Y. 1978).

Finally, in Count Four of the Complaint, plaintiffs allege that, during the summer of 1986, in a telephone conversation with Thomas Revy ("Revy")—a principal of plaintiff Froley, Revy—Sean Gallagher, a representative of defendant Furman Selz, characterized the debentures as including a " "special protection for debentureholders" in the event that the Company was subject to a takeover." Complaint at ¶ 14; *see also* Affidavit of Thomas Revy ("Revy Affidavit") at ¶ 3. Count Four further alleges that at a subsequent "due diligence" luncheon, "various officers" of Furman Selz stated to Revy that the debentures contained a " "protective covenant for the debentureholders" to protect against takeovers." Complaint at ¶ 43; *see also* Revy Affidavit at ¶ 4. Plaintiffs contend that, in light of defendants' subsequent assertion that the right to tender could be eliminated in the unrestricted discretion of the directors, the aforementioned statements were both materially false and, in conjunction with the prospectus, contained material omissions—all in violation of Section 12(2) of the Securities Act of 1933.

Despite defendants' urging, this Court hesitates to characterize these statements as mere puffing, and nothing more, though these remarks do appear to occupy the somewhat murky region between encouraging characterization and state-

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9 Indeed, *Beecher v. Able*, 374 F.Supp. 341 (S.D.N.Y. 1971), which is cited by plaintiffs in their Objections, underscores the very reason why an issuer may altogether eschew such prognostications, for in making forecasts, the issuer may also expose itself to additional liability for misleading disclosures.

ment of fact. *See, e.g., Klamberg*, 473 F. Supp. at 552 ("Of course, the distinction between facts and characterizations [or opinions] may not be a nice one"). Assuming for the purposes of this motion, however, that these remarks were intended to be statements of fact, and were accepted as such, we agree with the Magistrate that the plaintiffs have nevertheless failed to allege a "single untrue statement—material or otherwise—" within the purview of section 12(2).[10] R & R at 27. Under the conditions specified in both the Indenture and the prospectus, and particularly where the company might find itself subjected to an hostile takeover, the right to tender could, indeed, be "protective" of the debentureholders' interests. Finally, failure, on the part of the Furman Selz representatives, to elaborate upon the duties created by the right to tender no more constitutes an omission within the meaning of the securities laws than does the absence of such instruction in the prospectus or Indenture. Indeed, as the Magistrate indicated, this argument amounts to nothing more than a reassertion of the claims set forth in Counts Three and Five. R & R at 29.

Accordingly, because plaintiffs' federal claims fail to allege any omission or misstatement of fact—material or otherwise—within the meaning of the securities laws, they are dismissed pursuant to Fed.R.Civ.P. 56. Plaintiffs state law claims are dismissed for lack of pendent jurisdiction. *Walker v. Time Life Films, Inc.*, 784 F.2d 44, 53 (2d Cir.), *cert. denied*, 476 U.S. 1159 (1986) (absent exceptional circumstances, dismissal of state claims for lack of pendent jurisdiction is the recommended procedure in cases where all federal claims are disposed of prior to trial).

It Is So Ordered.

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10 Section 12(2) imposes liability upon any person who:

> offers to sell or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading . . .

Dated: New York, New York
May 22, 1989

/s/ MARY JOHNSON LOWE
United States District Court

Magistrate's Report & Recommendation

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

88 Civ. 0321 (MJL)

MCMAHAN & COMPANY, FROLEY, REVY INVESTMENT CO., INC. and WECHSLER & KRUMHOLZ, INC.,

Plaintiffs,

—against—

WHEREHOUSE ENTERTAINMENT, INC., LOUIS A. KWIKER, GEORGE A. SMITH, MICHAEL T. O'KANE, LAWRENCE K. HARRIS, DONALD E. MARTIN, JOEL D. TAUBER, FURMAN SELZ MAGER DIETZ & BIRNEY INCORPORATED, WEI ACQUISITION CORP., WEI HOLDINGS, INC., ADLER & SHAYKIN, and CHEMICAL BANK,

Defendants.

TO THE HONORABLE MARY JOHNSON LOWE:

Plaintiffs commenced this action on January 15, 1988, alleging breach of contract and violations of the federal securities laws in connection with the sale of convertible subordinated debentures; an amended complaint was filed on January 22. On January 27, plaintiffs moved for an order granting expedited discovery, and, on February 2, Your Honor referred the case to me for the supervision of pretrial discovery. By Order dated February 4, I denied plaintiffs' motion for expedited discovery and directed the parties to complete the requested discovery by April 1. That Order was specifically without prejudice to defendants' right to move for a stay of discovery in connection with the filing of a motion to dismiss the amended complaint.

On February 23, defendants Wherehouse Entertainment Inc., *et al.*,[1] moved for an order dismissing plaintiffs' amended complaint pursuant to Rules 12(b)(1) and 12(b)(6) of the Federal Rules of Civil Procedure and for a protective order staying discovery pending resolution of the motion to dismiss. On February 29, defendant Chemical Bank submitted a separate motion for dismissal under Rule 12(b)(1) for lack of jurisdiction over the subject matter. On March 9, plaintiffs submitted an "answering memorandum" and supporting affidavits in opposition to defendants' motions to dismiss the complaint. Defendants filed their reply on March 11.

On March 21, Your Honor referred defendants' motions to dismiss and for a protective order to me for Report and Recommendation. On March 22, the parties appeared before me and presented oral argument on the motion for a stay of discovery pending resolution of the motions to dismiss. By Order dated March 24, I granted defendants' motion to stay discovery pending resolution of the motions to dismiss.

At a conference on June 9, I advised the parties of my intention to treat defendants' 12(b) (6) motion to dismiss as a motion for summary judgment under Rule 56, Fed. R. Civ. P.,[2] and invited the parties to make any further submissions to the Court they deemed necessary and appropriate. I also expressed my view that plaintiffs had failed adequately to allege the factual bases for their federal securities-fraud claims.

On June 14, plaintiffs submitted a "Revised Amended Complaint" supplementing their fraud claims and adding a claim for damages under Section 12(2) of the Securities Act

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1 All defendants joined in this motion with the exception of Chemical Bank.

2 Conversion was proper, in my view, because plaintiffs had submitted a number of affidavits in opposition to defendants' motion, and because certain documents germane to the resolution of the lawsuit (an Indenture Agreement and Prospectus) were neither appended to nor specifically incorporated by reference in the amended complaint. *See Goldman v. Belden*, 754 F.2d 1059 (2d Cir. 1985).

of 1933, 15 U.S.C. § 77L. In response, defendants submitted a letter to the Court dated June 30, addressing the effect of the latest amendments on their pending motion. The parties have since represented to the Court that they do not intend to make any further submissions in connection with the summary judgment motion.

Plaintiffs claim that they are entitled to relief under both state and federal law. For the reasons set forth below, I find that there are no genuine issues of fact with respect to plaintiffs' federal securities claims and that defendants are entitled to judgment on these claims as a matter of law. I further find that, in the absence of a valid federal cause of action, it would be inappropriate to exercise pendent jurisdiction over the remaining state-law claims. I accordingly recommend that the federal claims be dismissed pursuant to Fed. R. Civ. P. 56 and that the state claims be dismissed pursuant to Fed. R. Civ. P. 12(b)(1).

BACKGROUND

Plaintiffs are financial institutions that are the record owners of certain convertible subordinated debentures of defendant Wherehouse Entertainment, Inc. ("Wherehouse").[3] On December 20, 1987, Wherehouse's Board of Directors unanimously approved (with one Director abstaining) a merger

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3 There are eleven named defendants. Wherehouse is a Delaware corporation that owns and operates a large number of record stores in the Western United States. *See* Revised Amended Complaint ¶ 9. Defendant Louis A. Kwiker is Chief Executive Officer, President, and a director of Wherehouse. *Id.* ¶ 10. Defendants George A. Smith, Donald E. Martin, Joel D. Tauber, Michael T. O'Kane, and Lawrence K. Harris all are directors of Wherehouse. *Id.* ¶¶ 11-15. (The term "Independent Directors" refers to all of the individual defendants named above with the exception of Kwiker.) Defendant WEI Acquisition Corp. is a wholly owned subsidiary of defendant WEI Holdings, Inc. *Id.* ¶ 17. Defendant WEI Holdings, Inc., is owned by defendant Adler & Shaykin, a partnership located in New York City. *Id.* ¶ 17. Defendant Furman Selz Mager Dietz & Birney, Incorporated ("Furman Selz"), is a corporation with its principal place of business in New York City. *Id.* ¶ 18. Finally, defendant Chemical Bank is a New York City banking corporation. *Id.* ¶ 19.

agreement with defendants WEI Acquisition Corp. ("Acquisition") and WEI Holdings ("Holdings"). Pursuant to that agreement, on December 23, 1987, Acquisition commenced a tender offer for any and all shares of Wherehouse common stock at fourteen dollars per share. This offer closed on January 22, 1988, at which time over 90 percent of the shares were tendered and purchased. Acquisition has since been merged into Wherehouse.[4]

Plaintiffs' claims in this case are based on a special "right to tender" provided to debentureholders in the governing Indenture. *See* Revised Amended Complaint ¶¶ 2, 3; Exhibit A to Memorandum of Law in Support of Defendants' Motion to Dismiss the Amended Complaint and for a Protective Order Staying Discovery ("Def. Memo") (Indenture dated June 15, 1986, between Wherehouse and Bank of America National Trust and Savings Association). Section 5.02 of the Indenture provides, *inter alia*, that, if certain specifically defined "triggering events" occur, the debentureholders will have the right to sell their debentures to Wherehouse at a set redemption price. *See id.* at 11-12. The three types of triggering events are defined as follows:

> (a) A person or group * * * shall attain the beneficial ownership * * * of an equity interest representing at least 80% of the voting power for election of the Board of Directors of the Company *unless such attainment has been approved by a majority of the Independent Directors*;
>
> (b) The Company * * * consolidates or merges with any other person * * * *unless approved by a majority of the Independent Directors*;
>
> (c) The Company or any Subsidiary incurs, issues, assumes, guarantees or creates any Debt, or pledges any Company or Subsidiary assets to secure repay-

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4 Although the parties advised the Court that the merger took place shortly after the action was filed on January 15, 1988, plaintiffs' Revised Amended Complaint continues to make reference to "the proposed merger." *See id.* ¶¶ 23, 27, 50, 57.

> ment of any Debt, *excluding Debt existing on July 9, 1986 and Debt which is authorized or ratified by a majority of the Independent Directors* * * *.

Id. (emphasis supplied).

Although plaintiffs concede that the Independent Directors approved the merger of Acquisition and Wherehouse, *see* Revised Amended Complaint ¶ 25, they contend that the Independent Directors breached a "contractual obligation" to consider the "best interest of the debentureholders" by approving the merger and thus waiving the debentureholders' conditional right under the Indenture to redemption. *See* Revised Amended Complaint ¶¶ 24-25; Plaintiffs' Answering Memorandum ("Pl. Memo") at 4-40. They claim that "[t]he transaction * * * trigger[ed] all three of the events set forth in the right to tender, * * * leav[ing the company] with insufficient cash flow and underlying capital to provide adequate security for the holders of the Subordinated Debentures." Revised Amended Complaint ¶ 23. As a result of the merger, plaintiffs claim that Wherehouse's debt will approach 90 percent of its capitalization, and that the debentureholders will lose their right to redeem the debentures at 106.25 percent of par, and will instead be left with bonds valued at approximately 50 percent of par. *Id.* at ¶ 26. In their memorandum to the Court, plaintiffs represent that "[t]he loss to all the debentureholders totals over $28 million (or over half the investment made only 20 months ago)." Pl. Memo at 2.

Counts One, Two, Six, and Seven are predicated on state law; jurisdiction for these claims is based on the doctrines of pendent and ancillary jurisdiction. *See* Revised Amended Complaint ¶ 4. Count One alleges that, by approving the merger (and thereby waiving the debentureholders' conditional right to redemption), the Independent Directors "breached the obligations and duties to the debentureholders created under the Indenture." *Id.* ¶ 25. Count Two alleges that the decision by the Independent Directors to approve the merger "breached the [Independent Directors'] contractual obligation to deal fairly and in good faith with the debentureholders." *Id.* ¶ 31. Count Six alleges that the defendants

"knowingly interfered" with the debentureholders' contractual "right to tender." *Id.* ¶ 53. Count Seven, the last of plaintiffs' state-law claims, alleges that "[t]he Merger * * * constitute[s] the incurrence of an obligation and a conveyance without fair consideration under applicable fraudulent conveyance statutes." *Id.* ¶ 57.[5]

Counts Three, Four, and Five of the Revised Amended Complaint allege violations of the federal securities laws and are made expressly conditional on the *failure* of plaintiffs' claims under state law. Count Three states that, "[i]f it is determined, *contrary to plaintiffs' position*, that the directors *could* properly waive the right to tender on a transaction that materially injures the debentureholders, then plaintiffs are entitled to damages against Wherehouse, the Directors and defendant Furman Selz, based on material omissions in the Registration Statement for the Debentures and in the prospectus for the Debentures dated July 10, 1986 (the 'Prospectus')." *Id.* ¶ 33 (emphases supplied). Plaintiffs argue that, since "[t]he Prospectus nowhere suggests that the right to tender is not intended for the benefit of the debentureholders * * * [or] * * * that the Independent Directors may waive the right in a situation where the triggering events adversely affect debentureholders" (*id.* ¶ 35), the Prospectus "contained material misstatements and omissions" in violation of

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5 Count Seven is asserted against all defendants including Chemical Bank; it is the *only* claim asserted against Chemical Bank. In Count Seven, plaintiffs claim that the merger violated "applicable fraudulent conveyance statutes" because:

> (i) In the proposed Merger, Wherehouse will be combined with a shell entity with enormous debt provided by Chemical Bank, which will be secured by Wherehouse assets, without Wherehouse's receiving therefor, in good faith, fair equivalent property; (ii) The Merger will render Wherehouse insolvent and leave Wherehouse with property remaining in its hands that is an unreasonably small capital to meet its obligations to debentureholders and other creditors; and (iii) Wherehouse intends or believes that by reason of the Merger it will incur debts beyond its ability to pay them as they mature.

Revised Amended Complaint ¶ 57.

§ 11 of the Securities Act of 1933, 15 U.S.C. § 77k.[6] *Id.* ¶¶ 38, 40.

Count Four, set forth for the first time in plaintiffs' Revised Amended Complaint, alleges a violation of Section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77L.[7] As with Count Three, Count Four arises only upon the failure of plaintiffs' claim that the Independent Directors were obligated to consider the debentureholders' best interests before waiving the right to redeem. Count Four alleges that various

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6 Section 11 provides, *inter alia*:

> (a) In case any part of the registration statement . . . contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security * * * may * * * sue—
>
> (1) every person who signed the registration statement;
>
> (2) every person who was a director of * * * or partner in the issuer at the time or the filing of the part of the registration statement with respect to which his liability is asserted; * * *
>
> If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission * * *.

7 Section 12(2) provides, *inter alia*:

Any person who—

> (2) offers or sells a security * * * by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, * * * to recover the consideration paid for such security with interest thereon, * * * upon the tender of such security, or for damages if he no longer owns the security.

officers and representatives of defendant Furman Selz orally represented to plaintiffs that the debentures contained a "protective covenant" for the debentureholders to protect against takeovers; that "[t]hese oral representations, along with statements contained in the prospectus, led [plaintiff] Revy to believe that the purpose of the right to tender was to protect debentureholders and that his investment would be returned to him in the event the harmful effects of a merger or excess debt occurred"; and that "Furman Selz's statements were materially false and misleading in light of defendants' subsequent assertion that the right to tender may be eliminated in the unrestricted discretion of the Independent Directors." Revised Amended Complaint ¶¶ 42-46.

Count Five, the last of the federal securities claims, alleges that "[t]he Company * * * knowingly omitted to state in the Registration Statement and Prospectus, or omitted to do so with reckless disregard for the interests of purchasers of the Debentures, that neither the Company nor the Directors had any intention of making the determination whether to waive the right to tender from the standpoint of the debentureholders." *Id.* ¶ 51. Plaintiffs claim that "[t]his willful and material omission operated as a fraud upon and injured plaintiffs" (*id.*), in violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j.[8]

Defendants argue that Counts One through Six of the Revised Amended Complaint should be dismissed on the merits.[9] Defendants' challenge to the state-law causes of action

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8 Section 10(b) of the Securities Exchange Act of 1934 provides:

It shall be unlawful for any person, * * * by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

9 Count Seven (the fraudulent conveyance claim) is the only cause of action not challenged by defendants' Rule 12(b)(6) motion to dismiss.

(Counts One, Two, and Six) is premised on a literal reading of the Indenture, which provides that the debentureholders' right to tender shall be triggered upon the occurrence of any of three types of transactions or events, *unless a majority of the Independent Directors*[10] *approves that transaction.* According to defendants, this language gives the Independent Directors the "unrestricted discretion to approve or disapprove any potentially 'triggering' transaction based on their own business judgment." Def. Memo at 6. Since Wherehouse's Independent Directors unanimously approved the merger between Wherehouse and Acquisition, defendants argue that plaintiffs have no valid causes of action for breach of contract (Count One), breach of the duty of good faith and fair dealing (Count Two), or intentional interference with contract (Count Six).[11]

With respect to the federal claims (Counts Three, Four, and Five), defendants argue that the rights of the parties under the Indenture were completely and accurately disclosed in both the Indenture and the Prospectus. *See* Def. Memo at 5-7. Given the clarity of the Indenture and the Prospectus, defendants argue that the failure expressly to state in the Prospectus that the Independent Directors could waive the redemption right without regard to the best interests of the debentureholders cannot be viewed as a "material omission" within the meaning of the federal securities laws. Defendants argue further that, contrary to plaintiffs' position, the condi-

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10 Under Section 5.02, " '*Independent Director*' means a director of the Company who is not, and has not been during the 5 years prior thereto, an employee of the Company and who either was a member of the Board of Directors of the Company on July 10, 1986, or who subsequently became a director of the Company and whose election, or nomination for election, by the Company's shareholders was approved by a vote of a majority of the Independent Directors then on the Board of Directors." Def. Memo Exhibit A at 12.

11 Defendants specifically argue that Count I must fail because the Independent Directors approved this transaction and thus the right to redeem was never triggered; Count II must fail because this doctrine cannot be used to create rights inconsistent with or at variance with the rights spelled out in the Indenture; and Count V must fail because no one interfered with any right that is actually contained in the Indenture. *See* Def. Memo at 5, 7.

tional redemption right provides a valuable benefit to debentureholders in the event that Wherehouse is subject to a hostile takeover. Defendants therefore argue that there was nothing false or misleading in representing to plaintiffs that the debentures contained a covenant for the benefit of the debentureholders.

Defendants also have moved to dismiss all of plaintiffs' state-law claims (Counts One, Two, Six, and Seven) pursuant to Fed. R. Civ. P. 12(b)(1) on the ground that this Court should not exercise pendent jurisdiction over the state-law causes of action absent a valid federal claim. *See* Def. Memo at 27-31. In a separate 12(b)(1) motion to dismiss, defendant Chemical Bank argues that Count Seven should be dismissed for lack of pendent-party jurisdiction. *See* Chemical Bank's Memorandum of Law filed in Support of Motion to Dismiss ("Chem. Memo"); Reply Memorandum in Further Support of Defendant Chemical Bank's Motion to Dismiss ("Chem. Reply").

DISCUSSION

Summary judgment may be granted only where "there is no genuine issue as to any material fact and * * * the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c). *See also Anderson v. Liberty Lobby*, 477 U.S. 242, 106 S. Ct. 2505, 2511 (1986); *Lopez v. S.B. Thomas, Inc.*, 831 F.2d 1184, 1187 (2d Cir. 1987). The burden rests on the moving party to demonstrate the lack of a genuine issue of fact, *Adickes v. S.H. Kress & Co.*, 398 U.S. 144, 157 (1970); *Clements v. Nassau County*, 835 F.2d 1000, 1004 (2d Cir. 1987); *Donahue v. Windsor Locks Board of Fire Commissioners*, 834 F.2d 54, 57 (2d Cir. 1987); *Williams v. Smith*, 781 F.2d 319, 323 (2d Cir. 1986); *Heyman v. Commerce & Industry Insurance Co.*, 524 F.2d 1317, 1320 (2d Cir. 1975), and the record must be viewed in the light most favorable to the party opposing the motion. *United States v. Diebold, Inc.*, 369 U.S. 654, 655 (1962); *Knight v. United States Fire Insurance Co.*, 804 F.2d 9, 11 (2d Cir. 1986), *cert.*

denied, 107 S. Ct. 1570 (1987). There must also be no controversy as to the inferences to be drawn from the facts, and the court must resolve all ambiguities and draw all inferences against the moving party. *Wakefield v. Northern Telecom, Inc.*, 813 F.2d 535, 540 (2d Cir. 1987); *EEOC v. Home Insurance Co.*, 672 F.2d 252, 256-57 (2d Cir. 1982); *American International Group Inc. v. London American International Corp.*, 664 F.2d 348, 351 (2d Cir. 1981).

Not all alleged factual disputes will defeat a motion for summary judgment; "the requirement is that there be no *genuine* issue of *material* fact." *Anderson*, 477 U.S. at 248 (emphasis in original). Material facts are determined by the substantive law underlying the action: "[o]nly disputes over facts that might affect the outcome of the suit under the governing law will properly preclude the entry of summary judgment." *Id.*; *see also Knight*, 804 F.2d at 11-12; *Quarles v. General Motors Corp.*, 758 F.2d 839, 840 (2d Cir. 1985).

While the burden of demonstrating the absence of any genuine issues of material fact is a difficult one to meet, motions for summary judgment, when properly employed, permit a court to terminate frivolous claims and to concentrate its resources on meritorious litigation. *Knight*, 804 F.2d at 12. As the Supreme Court has stated, a motion for summary judgment is properly regarded as:

> an integral part of the Federal Rules as a whole, which are designed 'to secure the just, speedy and inexpensive determination of every action' * * * Rule 56 must be construed with due regard not only for the rights of persons asserting claims and defenses that are adequately based in fact * * *, but also for the rights of persons opposing such claims and defenses to demonstrate in the manner provided by Rule, prior to trial, that the claims and defenses have no factual basis.

Celotex Corp. v. Catrett, 477 U.S. 317, 327 (1986).

Although summary judgment ordinarily is inappropriate in federal securities cases involving alleged misstatements or

omissions of material fact,[12] I find that plaintiffs here have failed even to make a *threshold* showing of an affirmative misrepresentation or omission within the meaning of the federal securities laws. It is therefore unnecessary to consider the potential significance of the alleged misstatements or omissions in the mind of a "reasonable investor." Because the issue of materiality never arises, I find that there are no genuine issues of disputed fact barring entry of summary judgment for the moving party.[13]

Federal Securities Claims:

Plaintiffs' claims under the federal securities laws allege both omissions and affirmative misrepresentations with respect to the debentureholders' conditional right to tender under Section 5.02 of the Indenture. Counts Three and Five concern alleged omissions in the Prospectus. Count Three under Section 11 of the 1933 Act essentially claims that the Prospectus was materially misleading because it omitted to state that the Independent Directors may waive the right to

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12 Under the federal securities laws, the materiality of an alleged misstatement or omission is a "mixed question of law and fact * * *." *Goldman v. Belden*, 754 F.2d 1059, 1067 (2d Cir. 1985); *see also TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 450 (1976). In *Goldman*, the Second Circuit held that "a complaint may not properly be dismissed pursuant to Rule 12(b)(6) (or even pursuant to Rule 56) on the ground that the alleged misstatements or ommission are not material unless they are so obviously unimportant to a reasonable investor that reasonable minds could not differ on the question of their importance." *Goldman*, 754 F.2d at 1067; *see also Kronfeld v. Trans World Airlines, Inc.*, 832 F.2d 726, 731 (2d Cir. 1987), *cert. denied*, 108 S. Ct. 1470 (1988); *GAF Corp. v. Heyman*, 724 F.2d 727, 737 (2d Cir. 1983); *Seibert v. Sperry Rand Corp.*, 586 F.2d 949, 951 (2d Cir. 1978); *Joyce v. Joyce Beverages, Inc.*, 571 F.2d 703, 707 (2d Cir.), *cert. denied*, 437 U.S. 905 (1978); *Mendell v. Greenberg*, 612 F. Supp. 1543, 1548-49 (S.D.N.Y. 1985).

13 The only "fact issues" alleged by plaintiff concern the materiality of the alleged omissions and misstatements in the mind of a "reasonable investor." *See* Pl. Memo at 38-39. However, since I find that plaintiffs have failed to allege any omissions or misstatements within the meaning of the federal securities laws, it is unnecessary to reach the materiality question: plaintiffs' claims are simply inadequate as a matter of law.

tender in a situation where the triggering events adversely affect debentureholders. *See* Revised Amended Complaint ¶ 35. Count Five incorporates by reference the alleged omissions described in Count Three and, in recognition of the scienter requirement of Rule 10(b) of the 1934 Act,[14] additionally alleges that the Prospectus was misleading because it omitted to state that "neither the Company nor the Directors had any intention of making the determination whether to waive the right to tender from the standpoint of the debentureholders." *See id.* ¶ 51. Count Four under Section 12(2) of the 1933 Act alleges both affirmative oral statements and omissions on the part of representatives and officers of defendant Furman Selz misrepresenting the extent to which the conditional redemption right would protect the debentureholders in the event of a merger.

Since plaintiffs' federal claims arise only if the state-law claims are rejected,[15] my analysis of the federal claims proceeds from the assumption that the Independent Directors in fact had the unrestricted discretion to "waive" the conditional-redemption right provided by Section 5.02 of the Indenture. Given this assumption, the first question is whether the lack of an explicit reference in the Prospectus to

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14 Both Section 11 of the Securities Act of 1933 and Section 10(b) of the Securities Exchange of 1934 require a plaintiff to allege and prove that a registration statement or prospectus contained a misstatement or omitted to state a material fact necessary to make the statements made not misleading. *See Rubin v. Long Island Lighting Co.*, 576 F. Supp. 608, 612 (E.D.N.Y. 1984). The difference between the two provision is that, unlike Section 11, Section 10(b) and accompanying Rule 10(b) (5) require a showing of scienter. *See id.* at 612 n.7; *see also Elfenbein v. American Financial Corp.*, 487 F. Supp. 619, 626 (S.D.N.Y. 1980), *aff'd*, 652 F.2d 53 (2d Cir. 1981).

15 As noted above, the federal claims are predicated on the failure of plaintiffs' claims under state law: this is because success on the common-law claims depends on a showing that the Independent Directors *were* subject to an express or implied duty to consider the debentureholders' best interests before waiving the conditional right to redeem provided under Section 5.02 of the Indenture. In the event of such a showing, there could be no claim that the Prospectus is misleading along the lines suggested by plaintiffs. Nor could plaintiffs argue that there was anything misleading about the Furman Selz representatives' assurances that the Indenture contained a protective covenant for the debentureholders' benefit.

the "unrestricted discretion" of the Independent Directors constitutes an omission within the meaning of the federal securities laws.

I conclude that it does not. The Prospectus expressly states that the right to redemption is *not* triggered if a majority of the Independent Directors approves the transaction; the language of the Prospectus is clear, unequivocal, and virtually identical to the above-quoted language of Section 5.02 of the Indenture. *See* Def. Memo Exhibit B at 3, 26.[16] Although is it true that "[t]here is no reference [in the Prospectus] to 'unrestricted discretion' or to the standard to be used by the Independent Directors" (Pl. Memo at 31), "legal conclusions or characterizations" do not constitute omissions within the meaning of the securities laws. *Koppel v. Wien*, 575 F. Supp. 960, 967-68 (S.D.N.Y. 1983) (failure to disclose that aspects of proposal set forth in proxy solicitation violated state or federal law not omissions within the contemplation of Section 14(a) of the 1934 Act), *aff'd in part and rev'd in part*, 743 F.2d 129 (2d Cir. 1984) (reversing summary dismissal of plaintiffs' motion for attorney's fees). *See also Data Probe Acquisition Corp. v. Datatab, Inc.*, 722 F.2d 1, 5-6 (2d Cir. 1983) (the disclosure required by the federal securities laws is not a "rite of confession or exercise in common law pleading. What is required is the disclosure of *material objective factual matters*") (emphasis supplied), *cert. denied*, 465 U.S.

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16 In describing the "Optional Debenture Tender," the Prospectus specifically provides that the debentureholders will have the option to require the Company to redeem such debentures:

> in the event that: (i) any person or group * * * attains beneficial ownership . . . of at least 80% of the voting power for election of the Company's directors *unless approved by a majority of the Company's Independent Directors*; (ii) the Company consolidates with, merges into or sells or leases its properties and assets substantially as an entirety to any person or entity, *unless approved by a majority of the Company's Independent Directors*; or (iii) the Company or any Subsidiary incurs Debt (*excluding * * * Debt authorized or ratified by a majority of the Company's Independent Directors*).

Def. Memo Exhibit B at 25-26 (emphasis supplied). *See also id.* at 3 (Prospectus Summary; virtually identical language).

1052 (1984);[17] *Gulf & Western Industries, Inc. v. Great Atlantic & Pacific Tea Co., Inc.*, 476 F.2d 687, 697 (2d Cir. 1973) ("the disclosure requirements of the securities laws require 'nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative experience in reaching their own investment decisions' ") (quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969)); *Nemo v. Allen*, 466 F. Supp. 192, 195 (S.D.N.Y. 1979) (claims asserted under Sections 13(a) and 14(a) of the 1934 Act dismissed because proxy materials disclosed all facts pertaining to former president's illegal activities and because "[t]here is simply no requirement in the Securities Laws * * * that [the former president's] actions be characterized as criminal in nature. All that need be disclosed are the facts from which a stockholder may draw its own conclusion").[18] As for plaintiffs' claim that the Prospectus "gave the misleading impression that the right

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17 In *Data Probe*, plaintiff Data Probe, Inc., ("Data Probe") sued to enjoin the merger of defendants CRC Acquisition Corp. ("CRC") and Datatab, Inc. ("Datatab"). In its complaint, Data Probe, which was itself attempting to gain control of Datatab through a tender offer, alleged, *inter alia*, that a letter written by Datatab to its shareholders recommending that the shareholders not tender their shares in response to the Data Probe tender offer violated the disclosure requirements of Section 14(e) of the Securities Exchange Act of 1934. Plaintiff alleged that the letter misleadingly failed to disclose that an outstanding option to purchase Datatab's shares held by defendant CRC would, if exercised, effectively guarantee that CRC could acquire Datatab regardless of how many of the outstanding shares were tendered to Data Probe. The trial court found that the letter violated Section 14(e) because, although the letter clearly described the terms of the CRC option to purchase Datatab's shares, it "drew no explicit connection between the grant of the option and the likely outcome of the struggle for control of Datatab." *Id.*, 722 F.2d at 3-5. The Second Circuit reversed, holding that management had satisfied its disclosure obligations by describing the terms of the CRC option to purchase Datatab shares in the letter to Datatab shareholders. *See id.* at 6.

18 As defendants correctly point out, the cases cited by plaintiffs in support of their federal securities claims are inapplicable here, because, in each of those cases, the defendants had made statements that obfuscated the objective facts or had omitted material facts. *See, e.g., Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1295-98 (2d Cir. 1973) (proxy statement found

to tender gave debentureholders protection against mergers and highly leveraged transactions," this argument ignores the fact that the right to tender *does* indeed provide a real benefit to debentureholders in the event that Wherehouse is subjected to a hostile takeover.[19] Indeed, the "antitakeover effect" of the right to tender provision is specifically described in the Prospectus immediately following the description of the "Optional Debenture Tender." *See* Def. Memo Exhibit B at 26-27. Finally, there is no merit to plaintiff's challenge to the Prospectus on the ground that it fails to state that "neither the Company nor the Directors had any intention of making the determination whether to waive the right to tender from the standpoint of the debentureholders." Revised Amended Complaint ¶ 51. Whatever the nature of defendants' intention with respect to the optional-tender provision, failure to disclose "underlying motives" does not constitute an omis-

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to be misleading because it falsely implied that defendant was not planning to sell its remaining outdoor advertising plants); *SEC v. First American Bank & Trust Co.*, 481 F.2d 673, 678-79 (8th Cir. 1973) (statement by financial institution that it was insured was materially misleading since its insurance was insufficient to insure the safety of the deposit, trust and contingent liabilities); *Hundahl v. United Benefit Life Insurance Co.*, 465 F. Supp. 1349, 1365 (N.D. Tex. 1979) (failure to disclose existence of restrictions on dividend declarations could have created liability under Rule lOb-5); *Beecher v. Able*, 374 F. Supp. 341, 346-47 (S.D.N.Y. 1974) (a statement by an issuer that substantial profits were improbable was held to be misleading since a reasonable investor would have concluded that substantial losses were also improbable); *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544, 574-75 (E.D.N.Y. 1971) (failure to include an estimate of $100,000,000 surplus held to be misleading).

19 As defendants correctly point out in their reply memorandum to the Court, "the express language [of the Indenture] provides the quite valuable right to redemption at par in the event of certain transactions not approved by the Independent Directors [*e.g.*, hostile takeovers], as well as the right to interest (Section 6.01); the right to convert into common stock (Section 12.01); the right to receive additional interest in the event of a default (Section 2.12); and the right to participate in a sinking fund and to acceleration of principal and interest due on the debentures in the event of a default (Art. 4 and Section 8.02)." Reply Memorandum in Support of Defendants' Motion to Dismiss the Amended Complaint and for a Protective Order Staying Discovery ("Def. Reply") at 9-10 (footnote omitted).

sion of material fact within the meaning of the federal securities laws. *See Koppel*, 575 F. Supp. at 967 (failure to disclose underlying motives does not violate Section 14(a) of the Securities Exchange Act of 1934 since "[t]he proxy rules require disclosure of the provisions, not the putative reasons behind proposing them") (citing *Lewis v. Oppenheimer & Co.*, 481 F. Supp. 1199, 1204 (S.D.N.Y. 1979); *Panter v. Marshall Field & Co.*, 646 F.2d 271, 290 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981)); *cf. Luce v. Edelstein*, 802 F.2d 49, 55 (2d Cir. 1986) ("making a *specific promise* to perform a particular act in the future while secretly intending not to perform that act may violate Section 10(b) where the promise is part of the consideration for the transfer of securities") (citations omitted; emphasis supplied); *Pross v. Katz*, 784 F.2d 455, 457 (2d Cir. 1986) (same). *But cf. Gulf & Western*, 476 F.2d at 696 (failure to disclose intention, when announcing tender offer, to take control of A & P or to participate extensively in its management constituted a violation of § 14(e)).

Since the Prospectus at issue clearly discloses all material facts (as opposed to legal conclusions) relating to the debentureholders' right to tender under Section 5.02 of the Indenture, I find that there is no basis for plaintiffs' claims that the Prospectus violated the disclosure requirements of Section 11 of the 1933 Act or Section 10(b) of the 1934 Act (Counts Three and Five).[20] *See Rubin*, 576 F. Supp. at 612 ("[w]hen

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20 Plaintiffs' reliance on *Harris v. Union Electric Co.*, 787 F.2d 355 (8th Cir.), *cert. denied*, 107 S. Ct. 94 (1986), is clearly misplaced. *See* Pl. Memo at 32. In *Harris*, the plaintiffs claimed that a prospectus misrepresented and omitted material facts regarding the "call protection provisions" of a bond contract, and that the attempted plan to call the bonds constituted a scheme to defraud the bondholders because the company knew that the plan was "contrary to and prohibited by the terms of the prospectus." The defendants argued, *inter alia*, that the prospectus clearly disclosed the company's right to call the bonds in the manner in which the plan provided. *Id.* at 361. In holding that the evidence supported the jury's finding that defendants' conduct operated as a fraud on the bondholders, the *Harris* Court wrote:

considering claims of material omissions under § 11 . . . and § 10(b) . . . , there is no question that they stand or fall together for the simple reason that both provisions impose liability for material omissions in virtually identical language"). I accordingly reject plaintiffs' contention that these claims raise disputed issues of fact barring entry of summary judgment for the moving party.

Count Four of the Revised Amended Complaint adds a claim under Section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77L, based on oral statements allegedly made by officers and representatives of defendant Furman Selz to the effect that the debentures included a "special protection for debentureholders" and a "protective covenant" in the event of a takeover. *See* Revised Amended Complaint ¶¶ 42-43. Plaintiffs claim that these oral statements led plaintiff Thomas Revy to believe that the purpose of the right to tender was to protect debentureholders and that his investment would be returned to him in the event the harmful effects of a merger or excess debt occurred. *See id.* ¶ 44. Plaintiffs also claim that, "[i]n view of the Prospectus and the oral representations by Furman Selz, the failure to state that the right to tender could be eliminated in the unrestricted discretion of a majority of the directors constituted an omission to state a material fact necessary in order to make statements made, in light of the circumstances, not misleading." *Id.* ¶ 46. *See also* Letter to the Court dated July 6, 1988; Affidavit of Thomas

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> it is clear that the jury could have reasonably found that the prospectus is ambiguous and misleading *in that it omits material facts [as set forth in the bond contract] concerning the call protection.*

Id. at 364 (emphasis supplied). Citing *Harris*, plaintiffs argue that the Prospectus "failed to disclose that the Independent Directors could act . . . with 'unrestricted discretion' to nullify the right to tender, and gave the misleading impression that the right to tender gave debentureholders protection against mergers and highly leveraged transactions." Pl. Memo at 32-33. This argument is fatally defective in that, unlike the prospectus in *Harris*, the Prospectus here does not omit *any* facts with respect to the right to tender as set forth in the Indenture Agreement. Instead, the language of the Prospectus virtually mirrors that of Section 5.02 and in so doing clearly discloses that the optional right to tender only arises upon the occurrence of certain transactions not approved by a majority of the Independent Directors.

Revy (financial analyst and a principle of plaintiff Foley, Revy Investment Co., Inc.) ("Revy Aff.").[21]

As with Counts Four and Five, I find that there are no genuine issues of disputed fact with respect to the allegations set forth in Count Four and that defendants are entitled to judgment as a matter of law. Section 12(2) of the Securities Act of 1933 imposes liability upon any person who:

> offers to sell or sells a security * * * by means of a prospectus or oral communication, which includes an *untrue statement* of a material fact or omits to state a material fact necessary in order to make the statements * * * not misleading * * *.

15 U.S.C. § 77L (emphasis supplied). *See also Franklin Sav. Bank of New York v. Levy*, 551 F.2d 521, 525 (2d Cir. 1977); *Elfenbein v. American Financial Corp.*, 487 F. Supp. 619, 626 (S.D.N.Y. 1980), *aff'd mem.*, 652 F.2d 53 (2d Cir. 1981).

Assuming, as I must, the truth of plaintiffs' allegations, and drawing all inferences in favor of the non-moving party, the fact remains that plaintiffs have failed to allege a single "untrue statement"—material or otherwise—made with respect to the debentureholders' right to tender under the governing Indenture. As discussed *supra* at 22-23, the conditional redemption right in fact provides a valuable benefit to debentureholders in the event Wherehouse is subjected to a takeover not approved by a majority of the Independent

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21 In his affidavit, Revy states that Mr. Sean Gallager, an officer of Furman Selz, described the securities as "includ[ing] a provisional protection from redemption by the Company and 'special protection for the debentureholders' in the event of a takeover." *See* Revy Aff. at ¶ 3. Later, at a "due diligence" luncheon on July 2, 1986, another Furman Selz representative allegedly described the debentures as containing "a protective covenant for the debentureholders." *Id.* ¶ 4. He claims that these oral statements, in conjunction with the description of the right to tender contained in the Prospectus, misled him into believing that the debentureholders were protected against the harmful effects of takeovers and leveraged buy-outs.

Directors.[22] Thus it was perfectly accurate for the Furman Selz representatives to assert that the debentures contained a protective covenant for the debentureholders' benefit. I therefore agree with defendants that "these alleged oral statements are on their face not fraudulent because they are true." *See* Letter to the Court dated June 30, 1988.

Notwithstanding the literal truth of the alleged misrepresentations, plaintiffs argue that the failure on the part of the Furman Selz representatives explicitly to state that the right to tender could be waived in the unrestricted discretion of the Independent Directors misleadingly exaggerated the extent of the protection afforded by the redemption provision. This argument essentially restates the claims asserted in Counts Three and Five with respect to allegedly material omissions in the Prospectus and is equally unpersuasive. As discussed *supra* at 20-22, legal conclusions or characterizations simply do not constitute "omissions" within the meaning of the federal securities laws. This claim accordingly fails as a matter of law.[23]

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22 In a letter to the Court dated June 14, 1988, plaintiffs claim that the right to tender is "illusory" because "over 90% of all acquisitions (including hostile takeovers) are concluded with the agreement of the pre-existing directors." Thus, plaintiffs appear to suggest that there is a disputed issue of fact as to whether the conditional tender option is of any benefit to the debentureholders. This contention is meritless. Even assuming, as plaintiffs suggest, that 90 percent of all acquisitions are concluded by agreement, the fact remains that the conditional redemption provision at issue in this case would protect debentureholders in the assumed 10 percent of acquisitions *not* approved by a majority of the independent directors. Therefore, although the parties disagree about the extent of the benefit provided by the conditional right to tender, plaintiffs do not allege any genuine issue as to whether this provision is of *any* benefit to the debentureholders; *i.e.*, they effectively concede that the tender provision benefits the debentureholders in the event the company is subjected to a takeover or merger not approved by the majority of the Independent Directors.

23 Even assuming *arguendo* that this type of omission was actionable under the securities law, it is virtually inconceivable that "any reasonable investor" could have been misled by the Furman Selz statements in light of the clear and unambiguous language of both the Indenture and the Prospectus.

To conclude, I find that defendants have met their burden of demonstrating the absence of any genuine issues of fact with respect to the federal securities claims. Since plaintiffs have failed to allege any misstatements or omissions of fact within the meaning of the federal securities law, it is unnecessary to reach the issue of whether a reasonable investor could have been misled by defendants' representations concerning the nature of the conditional right to tender the debentures. I accordingly recommend that Counts Three, Four, and Five be dismissed pursuant to Fed. R. Civ. P. 56.

State-Law Claims:

Counts One, Two, Six, and Seven are predicated on state law; jurisdiction for these claims is based on the doctrines of pendent and ancillary jurisdiction. *See* Revised Amended Complaint ¶ 4. Defendants argue that, in the absence of a valid federal claim, this Court should not exercise pendent jurisdiction over the remaining state-law claims, and that those claims should accordingly be dismissed pursuant to Fed. R. Civ. P. 12(b)(1). *See* Def. Memo at 27-31. Defendant Chemical Bank also moves to dismiss Count Seven on the ground that the Court lacks pendent-party jurisdiction over the fraudulent conveyance claim. *See* Chem. Memo; Chem. Reply.

Absent "exceptional circumstances," dismissal of state claims for lack of pendent jurisdiction is the recommended procedure in cases where all federal claims are disposed of prior to trial. *Walker v. Time Life Films, Inc.*, 784 F.2d 44, 53 (2d Cir.), *cert. denied*, 476 U.S. 1159 (1986). *See also United Mine Workers v. Gibbs*, 383 U.S. 715 (1966); *Dunton v. County of Suffolk*, 729 F.2d 903, 910-11 (2d Cir. 1984); *McLearn v. Cowen & Co.*, 660 F.2d 845, 848 (2d Cir. 1981); *IIT v. Vencap, Ltd.*, 519 F.2d 1001, 1015 (2d Cir. 1975); *Kaplan v. Shapiro*, 655 F. Supp. 336, 342 (S.D.N.Y. 1987); *International Paint Co. v. Grow Group, Inc.*, 648 F. Supp. 729, 731 (S.D.N.Y. 1986); *Packer v. Yampol*, 630 F. Supp. 1237, 1243 (S.D.N.Y. 1986); *Gramercy 222 Residents Corp. v. Gramercy Realty*, 591 F. Supp. 1408, 1415 (S.D.N.Y.

1984); *Lewis v. McGraw*, 495 F. Supp. 27, 33 (S.D.N.Y. 1979). Having recommended that Counts Three, Four, and Five be dismissed pursuant to Fed. R. Civ. P. 56, I further recommend that Counts One, Two, Six, and Seven be dismissed as against all defendants including Chemical Bank pursuant to Fed. R. Civ. P. 12(b) (1) for lack of jurisdiction over the subject matter.

CONCLUSION

In summary, I recommend that Counts Three, Four, and Five of the Revised Amended Complaint (the federal securities claims) be dismissed pursuant to Fed. R. Civ. P. 56. I further recommend that Counts One, Two, Six, and Seven of the Amended Complaint (the state-law claims) be dismissed pursuant to Fed. R. Civ. P. 12(b)(1) for lack of jurisdiction over the subject matter.

Pursuant to 28 U.S.C. § 636(b) (1) and Rule 72 of the Federal Rules of Civil Procedure, the parties shall have ten (10) days from receipt of this Report to file written objections. Such objections shall be filed with the Clerk of the Court, with extra copies delivered to the chambers of the Honorable Mary Johnson Lowe, Room 803, and to the chambers of the undersigned, Room 631. Any requests for an extension of time for filing objections must be directed to Judge Lowe. Failure to file objections may result in a waiver of those objections for purposes of appeal. *Thomas v. Arn*, 474 U.S. 140 (1985); *Wesolek v. Canadair Ltd.*, 838 F.2d 55, 57-59 (2d Cir. 1988); *McCarthy v. Manson*, 714 F.2d 234, 237-38 (2d Cir. 1983).

DATED: New York, New York
August 10, 1988

KATHLEEN A. ROBERTS
United States Magistrate

Prospectus (Excerpts)

(Cover Page)

$50,000,000

Wherehouse Entertainment, Inc.

6¼% Convertible Subordinated Debentures
Due July 1, 2006

The 6¼% Convertible Subordinated Debentures Due July 1, 2006 (the "Debentures") are being offered by Wherehouse Entertainment, Inc. (the "Company"). The Debentures are generally convertible at any time prior to maturity, unless previously redeemed, into shares of Common Stock of the Company (the "Common Stock") at a conversion price of $34.50 per share, subject to adjustment in certain circumstances. The Debentures are redeemable, in whole or in part, at the option of the Company on 30 days notice at 106.25% of their principal amount if redeemed prior to July 1, 1988, and thereafter at prices declining to 100% on or after July 1, 1994, together in each case with accrued interest; except that the Debentures are not redeemable prior to July 2, 1988, unless the closing price of the Common Stock on each of any 20 trading days within a period of 30 consecutive trading days immediately preceding the date of the notice of redemption of the Debentures has been at least 140% of the conversion price then in effect. Each holder of the Debentures has the option to require the Company to redeem the holder's Debentures upon certain defined events. Annual sinking fund payments of $3,500,000, commencing July 1, 1996, are calculated to retire 70% of the Debentures prior to maturity. The Debentures are unsecured obligations of the Company and subordinated in right of payment to all Senior Debt of the Company, as provided in the Indenture. The Indenture will not restrict the Company from incurring any other indebtedness. See "Description of Debentures."

The Company's Common Stock is traded on the American Stock Exchange. The last reported sale price of the Common

Stock on the American Stock Exchange on July 9, 1986 was $28 per share. See "Price Range of Common Stock." The Company has declared a one for four stock distribution payable on August 15, 1986 to shareholders of record on July 25, 1986. Prior to the date hereof, there has been no trading market for the Debentures. Application has been made to include the Debentures in NASDAQ.

THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

	Price to Public(1)	Underwriting Discounts(2)	Proceeds to Company(3)
Per Debenture	100%	2.8%	97.2%
Total (3)	$50,000,000	$1,400,000	$48,600,000

(1) Plus accrued interest, if any, from July 17, 1986 to the date of delivery.
(2) See "Underwriting" for information relating to indemnification of the Underwriter and other matters.
(3) Before deducting expenses estimated at $1,050,000 payable by the Company.

The Debentures are offered by the Underwriter, subject to prior sale and to receipt and acceptance by the Underwriter and subject to the Underwriter's right to reject any order in whole or in part. It is expected that delivery of the Debentures will be made on or about July 17, 1986.

Furman Selz Mager Dietz & Birney
Incorporated

The date of this Prospectus is July 10, 1986

(Prospectus, p. 3)

PROSPECTUS SUMMARY

The following summary should be read in conjunction with, and is qualified in its entirety by, the more detailed information and Consolidated Financial Statements (including the notes thereto) appearing elsewhere in this Prospectus.

The Company

Wherehouse Entertainment, Inc., is one of the largest specialty retailers in the United States of home-entertainment and information software, including prerecorded music, video movies and other video programming, blank video and audio tape and personal and home computer software. All 158 of the Company's stores sell prerecorded music on compact discs, cassettes and records, video movies and other video programming, and blank video and audio tapes. In addition, 114 stores rent video movies and 127 sell computer software. The Company's stores are located predominantly in California, with 25 stores located in five nearby Western States. The Company's stores are located predominantly in California, with 25 stores located in five nearby Western States. The Company believes that it rents more video movies than any other retailer in the United States and sells more prerecorded music and blank video and audio tape than any other retailer in California.

The Offering

Securities Offered...	$50,000,000 principal amount of 6¼% Convertible Subordinated Debentures Due July 1, 2006.
Interest Payment Dates.....	July 1 and January 1, commencing January 1, 1987.
Conversion Price ...	$34.50 per share, subject to adjust-

	ment upon the occurrence of certain events.
Optional Redemption.....	Redeemable at the Company's option at any time, in whole or in part, on 30 days' notice, at 106.25% of the principal amount if redeemed prior to July 1, 1988 and thereafter at prices declining to 100% on or after July 1, 1994, together in each case with accrued interest; except that the Debentures are not redeemable prior to July 2, 1988, unless the closing price of the Common Stock on each of any 20 trading days within a period of 30 consecutive trading days immediately preceding the date of the notice of redemption of the Debentures has been at least 140% of the conversion price then in effect.
Optional Tender....	Each holder of Debentures has the option to require the Company to redeem the holder's Debentures, in whole or in part, at the greater of the optional redemption price or the Conversion Value of the Debentures, in the event that (i) any person or group attains beneficial ownership of at least 80% of the voting power for election of the Company's directors unless approved by a majority of the Company's Independent Directors; (ii) there is a merger or sale of the Company unless approved by a majority of the Company's Independent Directors; or (iii) the Company or any Subsidiary incurs

	certain Debt (not approved by a majority of the Company's Independent Directors) whereby the Company's Consolidated Total Debt exceeds 65% of Consolidated Capitalization.
Sinking Fund	Mandatory annual payments of $3,500,000 commencing July 1, 1996 are calculated to retire 70% of the Debentures prior to maturity. The Company may deliver Debentures (including converted Debentures) in lieu of cash as a credit against sinking fund payments.
Subordination	Subordinated to all current and future Senior Debt of the Company.
Use of Proceeds....	To finance the Company's new store opening and expansion program, including the acquisition of certain assets of a California retailer of home entertainment software products, and to reduce indebtedness under the Company's bank line of credit.
Common Stock Information.....	7,118,867 shares of Common Stock outstanding.

(Prospectus, pp. 25-27)

Optional Debenture Tender

Holders of the Debentures will have the option, for a specified period of 60 days, to require the Company to redeem such Debentures, at the principal amount thereof, in whole or in part, at the greater of (a) the optional redemption price as of the date of the event giving rise to the right of redemption or (b) the average of the Conversion Values of the Debentures for the 20 trading days immediately preceding the date of such event (such "Conversion Value" of a Debenture on any day being equal to the closing price of a share of Common Stock on such day multiplied by the number of shares of Common Stock (including any fraction thereof) into which such Debenture is convertible on such day), in the event that: (i) any person or group (within the meaning of Section 13(d)(3) of the Securities Exchange Act of 1934) attains beneficial ownership (within the meaning of Rule 13d-3 of the Securities Exchange Act of 1934) of at least 80% of the voting power for election of the Company's directors unless approved by a majority of the Company's Independent Directors; (ii) the Company consolidates with, merges into or sells or leases its properties and assets substantially as an entirety to any person or entity, unless approved by a majority of the Company's Independent Directors; or (iii) the Company or any Subsidiary incurs Debt (excluding Debt existing on July 9, 1986, and Debt authorized or ratified by a majority of the Company's Independent Directors) whereby the Consolidated Total Debt of the Company exceeds 65% of its Consolidated Capitalization (as such terms are hereinafter defined). This provision permits the holders of the Debentures to require redemption prior to maturity in the event the Company undergoes certain changed conditions as described above.

A redemption of the Debentures pursuant to this option may adversely affect the Company's financial condition and the market price of the Common Stock. This optional tender provision may deter certain mergers, tender offers or other

takeover attempts. See "Description of Debentures–Effect on Certain Takeovers."

"Consolidated Capitalization" is defined to mean the Consolidated Total Debt of the Company and its Subsidiaries plus its shareholders' equity and any preferred stock or other capital stock classified as subject to redemption and not included in its shareholders' equity plus minority interests in its Subsidiaries, as defined in accordance with generally accepted accounting principles.

"Consolidated Total Debt" is defined to mean the total Debt of the Company and its Subsidiaries, computed and consolidated in accordance with generally accepted accounting principles.

"Debt" is defined to mean: (i) any indebtedness of the Company (a) for money borrowed (other than the Debentures), (b) evidenced by a note, debenture or similar instrument (including a purchase money obligation) given in connection with the acquisition of any property or assets (other than inventory or similar property acquired in the ordinary course of business), or (c) for the payment of money relating to a capitalized lease obligation; (ii) any guarantee by the Company of indebtedness for borrowed money or indebtedness incurred as described in (i)(b) above; and (iii) any renewal, extension, refunding or amendment of any such indebtedness, obligation or guarantee.

"Independent Director" is defined to mean a director of the Company who is not, and has not been during the five years prior thereto, an employee of the Company and who either was a member of the Board of Directors of the Company on July 10, 1986, or who subsequently became a director of the Company and whose election, or nomination for election by the Company's shareholders, was approved by a vote of a majority of the Independent Directors then on the Board of Directors. Any action, approval of which shall require the approval of a majority of the Independent Directors, may be authorized by one Independent Director if he is the only Independent Director on the Board of Directors, but no such action may be taken if there are no Independent Directors on the Board of Directors.

"Subsidiary" is defined to mean a corporation a majority of the voting stock of which is owned, directly or indirectly, by the Company or by one or more other Subsidiaries, or by the Company and one or more other Subsidiaries.

Rule 13e-4 under the Securities Exchange Act of 1934 requires the dissemination of certain information to security-holders in the event of any issuer tender offer and may apply in the event that the optional tender provision becomes available to the holders of the Debentures. The Company will comply with this Rule to the extent applicable at that time.

Effect on Certain Takeovers

Certain features of the Debentures may deter certain mergers, tender offers or other present or future takeover attempts and may thereby adversely affect the market price of the Common Stock. The Indenture also provides that holders of Debentures shall have the option to require the Company to redeem their Debentures, in whole or in part, upon the occurrence of certain specified events. See "Description of Debentures—Optional Debenture Tender." Since the events which give rise to such right of redemption could be expected to occur in connection with certain forms of takeover attempts, the optional tender provisions could deter takeovers where the person attempting the takeover views itself as unable to finance the redemption of the principal amount of Debentures which may be tendered to the Company upon occurrence of such specified event. To the extent that Debentures may be tendered pursuant to the optional tender provisions, the Company would be unable to use the financing provided by the sale of the Debentures offered hereby. In addition, the ability of the Company to obtain additional Senior Debt based on the existence of the Debentures would be similarly adversely affected. Certain takeover attempts may also be deterred by the Company's authorized but unissued preferred stock. See "Description of Capital Stock."

* * *

Indenture (Excerpts)

INDENTURE dated as of June 15, 1986, between WHEREHOUSE ENTERTAINMENT, INC., a Delaware corporation ("Company"), and BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION, a national banking association ("Trustee").

Each party agrees as follows for the benefit of the other party and for the equal and ratable benefit of the Holders of the Company's 6¼% Convertible Subordinated Debentures Due July 1, 2006 ("Securities"):

ARTICLE 1

DEFINITIONS AND INCORPORATION BY REFERENCE

SECTION 1.01 *Definitions.*

"*Affiliate*" means any person directly or indirectly controlling or controlled by or under direct or indirect common control with the Company.

"*Agent*" means any Registrar, Paying Agent, Conversion Agent or co-registrar.

"*Board of Directors*" means the Board of Directors of the Company or any authorized committee of the Board.

"*Company*" means the party named as such above until a successor replaces it and thereafter means the successor.

"*Default*" means any event which is, or after notice or passage of time would be, an Event of Default.

"*Holder*" or "Securityholder" means the person in whose name a Security is registered.

"*Indenture*" means this Indenture, as amended or supplemented from time to time.

"*Officer*" means the Chairman of the Board, the President, any Vice President, the Treasurer or the Secretary of the Company.

"*Officers' Certificate*" means a certificate signed by two Officers. See Sections 14.04 and 14.05.

"*Opinion of Counsel*" means a written opinion from legal counsel who is acceptable to the Trustee. The counsel may be an employee of or counsel to the Company or the Trustee. See Sections 14.04 and 14.05.

"*Principal*" of a debt security means the principal of the security plus the premium, if any, on the security.

"*SEC*" means the Securities and Exchange Commission.

"*Securities*" means the Securities described above issued under this Indenture.

"*TIA*" means the Trust Indenture Act of 1939 (15 U.S. Code §§ 77aaa-77bbbb) as in effect on the date of this Indenture.

"*Trustee*" means the party named as such above until a successor replaces it and thereafter means the successor.

"*Trust Officer*" means the Chairman of the Board, the President or any other officer or assistant officer of the Trustee assigned by the Trustee to administer its corporate trust matters.

SECTION 1.02 *Other Definitions.*

Term	*Defined in Section*
"Bankruptcy Law"	8.01
"Common Stock"	12.01
"Consolidated Capitalization"	5.02
"Consolidated Total Debt"	5.02
"Conversion Agent"	2.03
"Custodian"	8.01

Term	*Defined in Section*
"Debt"	13.02
"Event of Default"	8.01
"Independent Director"	5.02
"Legal Holiday"	14.07
"Paying Agent"	2.03
"Quoted Price"	14.13
"Registrar"	2.03
"Representative"	13.02
"Senior Debt"	13.02
"Subsidiary"	5.02
"U.S. Government Obligations"	10.01

* * *

ARTICLE 5

OPTIONAL SECURITYHOLDER TENDER

SECTION 5.01 *Holder's Right to Tender.* The Holder of any Security or Securities shall have the right, at his option, upon the giving of notice of the occurrence of any event described in Section 5.02, and subject to the terms and provisions of this Article, to tender for redemption any such Security or Securities, in whole or in any portion thereof that is an integral multiple of $1,000, without regard to whether the Securities are then redeemable under the optional redemption provisions of paragraph 5 of the Securities, for cash in an amount equal to the greater of (i) the applicable redemption price if such Securities were being redeemed pursuant to the optional redemption provisions of paragraph 5 of the Securities and (ii) the average of the conversion values of such Securities for the 20 consecutive trading days ending on the trading day immediately preceding the day on which the event giving rise to the right to tender shall have occurred, such conversion value of a Security on any day being equal to the Quoted Price of the Common Stock (determined as specified in Section 14.13) on such day multiplied by the number of shares of Common Stock (including any fraction thereof) into which such Security is convertible on such day

(the "tender redemption price"). The date of such redemption shall be the sixty-fifth day after the date of the notice provided pursuant to Section 5.03 (the "tender redemption date"). The Holder's right to tender shall continue up to the sixtieth day after the date of such notice and shall be exercised by surrender on or before such day of the Security or Securities to the Trustee accompanied by written notice that the Holder elects to tender such Security or Securities and (if so required by the Company or the Trustee) by a written instrument or instruments of transfer in form satisfactory to the Company and the Trustee duly executed by the Holder or his duly authorized legal representative and transfer tax stamps or funds therefor, if required pursuant to Section 12.04. All Securities surrendered for redemption shall be cancelled by the Trustee.

Section 5.02 *Events Triggering Holder's Right to Tender.* The Holder's right to tender under Section 5.01 shall be triggered upon the occurrence of any of the following events:

(a) A person or group (within the meaning of Section 13(d)(3) of the Securities Exchange Act of 1934) shall attain the beneficial ownership (within the meaning of Rule 13d-3 promulgated under the Securities Exchange Act of 1934) of an equity interest representing at least 80% of the voting power for election of the Board of Directors of the Company unless such attainment has been approved by a majority of the Independent Directors;

(b) The Company, directly or indirectly, consolidates or merges with any other person or sells or leases its properties and assets substantially as an entirety to any person, unless approved by a majority of the Independent Directors;

(c) The Company or any Subsidiary incurs, issues, assumes, guarantees or creates any Debt, or pledges any Company or Subsidiary assets to secure repayment of any Debt, excluding Debt existing on July 9, 1986 and Debt which is authorized or ratified by a majority of the

Independent Directors, immediately after the incurrence of which the ratio of the Company's Consolidated Total Debt to its Consolidated Capitalization exceeds .65 to 1.0; the ratio shall be calculated from the Company's latest published quarterly consolidated balance sheet, prepared in accordance with generally accepted accounting principles, adjusted on a pro forma basis as if such Debt existed as of the balance sheet date.

Capitalized terms used but not defined elsewhere in this Indenture have the meanings set forth below:

"*Consolidated Capitalization*" means the Consolidated Total Debt of the Company and its Subsidiaries plus its shareholders' equity and any preferred stock or other capital stock classified as subject to redemption and not included in its shareholders' equity plus minority interests in its Subsidiaries, as defined in accordance with generally accepted accounting principles.

"*Consolidated Total Debt*" means the total Debt of the Company and its Subsidiaries, computed and consolidated in accordance with generally accepted accounting principles.

"*Independent Director*" means a director of the Company who is not, and has not been during the 5 years prior thereto, an employee of the Company and who either was a member of the Board of Directors of the Company on July 10, 1986, or who subsequently became a director of the Company and whose election, or nomination for election, by the Company's shareholders was approved by a vote of a majority of the Independent Directors then on the Board of Directors. Any action, approval of which shall require the approval of a majority of the Independent Directors, may be authorized by one Independent Director if he is the only Independent Director on the Board of Directors, but no such action may be taken if there are no Independent Directors on the Board of Directors.

"*Subsidiary*" means a corporation, a majority of the voting stock of which is owned, directly or indirectly, by the Company or by one or more Subsidiaries, or by the Company and one or more other Subsidiaries.

SECTION 5.03 *Notice of Events.* Upon occurrence of any of the events described in Section 5.02, the Company shall file with the Trustee and shall mail to each Holder of Securities, as promptly as possible but in any event not more than 10 days following such occurrence, a notice stating that the event specified in the notice has occurred and that each Holder has the right to tender his Security or Securities for cash pursuant to the terms and provisions of this Article together with the form of the written notice of tender required by Section 5.01. Upon demand to the Company at any time by the Trustee or any Holder of Securities, such notice shall be filed with the Trustee and mailed to each Holder of Securities, unless the Company can demonstrate to the Trustee's satisfaction that no event described in Section 5.02 has occurred.

SECTION 5.04 *Deposit of Funds.* On or before the sixty-second day after the date of the notice provided pursuant to Section 5.03, the Company shall deposit with the Trustee or with a Paying Agent (or, if the Company is acting as its own Paying Agent, segregate and hold in trust as provided in Section 2.04) an amount of money sufficient to pay the tender redemption price plus accrued interest on all the Securities to be redeemed on the tender redemption date.

If any Security surrendered for redemption under this Article is converted, any money deposited with the Trustee or with any Paying Agent or so segregated and held in trust for the redemption of such Security shall be paid to the Company upon its request or, if then held by the Company, shall be discharged from such trust.

SECTION 5.05 *Securities Payable on Tender Redemption Date.* Notice having been given as aforesaid, the Securities to be redeemed shall, on the tender redemption date, become due and payable at a price equal to the tender redemption

price plus accrued interest and from and after such date (unless the Company shall default in such payment) such Securities shall cease to bear interest. Upon surrender of any such Security for redemption in accordance with Section 5.01, such Security shall be paid on the tender redemption date by the Trustee or Paying Agent at a price equal to the tender redemption price, together with accrued interest to the tender redemption date.

SECTION 5.06 *Securities Redeemed in Part.* Upon surrender of a Security that is redeemed in part, the Trustee shall authenticate for the Holder a new Security equal in principal amount to the unredeemed portion of the Security surrendered.

SECTION 5.07 *Default.* The occurrence of any of the events described in Section 5.02 shall not be deemed Events of Default under Section 8.01, except where provided otherwise in this Article. All other obligations of the Company provided in this Article shall be included as covenants of the Company for purposes of Events of Default pursuant to Section 8.01.

* * *

STATUTORY APPENDIX

Securities Act of 1933, § 11(a), 15 U.S.C. § 77k(a):

> (a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—
>
> (1) every person who signed the registration statement;
>
> (2) every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;
>
> (3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;
>
> (4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;
>
> (5) every underwriter with respect to such security.

If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement,

then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

Securities Act of 1933, § 12, 15 U.S.C. § 771:

> Any person who—
>
> (1) offers or sells a security in violation of section 5, or
>
> (2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,
>
> shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Securities Exchange Act of 1934, § 10, 15 U.S.C. § 78j:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of

interstate commerce or of the mails, or of any facility of any national securities exchange—

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.